CALIFORNIA 8-HOUR ANNUITY TRAINING

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I Historical Development of Annuity Contracts

An annuity originally referred to a constant annual payment. It now refers to a stream of regular payments. An annuity policy is a contract in which the insurer promises the insured (the ‘annuitant’), a regular series of payments. Annuities are sometimes referred to as ‘reverse life insurance.’ With life insurance, the policyholder pays the insurer each year until he or she dies, after which the insurance company pays a lump sum to the insured’s beneficiaries. With annuities, a lump-sum or periodic payments are made by the annuitant to the insurance company before the annuity payout begins, and the annuitant receives regular payouts from the insurer until death. Most annuity contracts have an *accumulation phase* and a *liquidation phase.* During the accumulation phase, capital builds up; this capital is dispersed during the liquidation phase.

A. How They Have Evolved

Not surprisingly, since uncertainty about length of life is a ubiquitous source of risk, financial contracts similar to annuities have a long history. James (1947) reports that ancient Roman contracts known as *annua* promised an individual a stream of payments for a fixed term, or possibly for life, in return for an up-front payment. Such contracts were apparently offered by speculators who dealt in marine and other lines of insurance. A Roman, Domitius Ulpianus, compiled the first recorded life table for the purpose of computing the estate value of annuities that a decedent might have purchased on the lives of his survivors. Single-premium life annuities were available in the Middle Ages, and detailed records exist of special annuity pools known as *tontines* that operated in France during the 17th century. In return for an initial lump-sum payment, purchasers of tontines received life annuities. The amount of the annuity was increased each year for the survivors, as they claimed the payouts that would otherwise have gone to those who died. When the second-to- last participant in a tontine pool died, the survivor received the entire remaining principal. The tontine thus combined insurance with an element of lottery-style gambling. During the 1700's, governments in several nations, including England and Holland, sold annuities in lieu of government bonds. The government received capital in return for a promise of lifetime payouts to the annuitants. There are detailed accounts of the sale of public annuities in England in the18th and early 19th centuries[1]. Annuities initially were sold to all individuals at a fixed price, regardless of their age or sex. As it became clear over time that mortality rates for annuitants were lower than those for the population at large, a more refined pricing structure was introduced. In the United States, annuities have been available for over two centuries. In 1759, Pennsylvania chartered the Corporation for the Relief of Poor and Distressed Presbyterian Ministers and Distressed Widows and Children of Ministers. It provided survivorship annuities for the families of ministers (see James 1947). In Philadelphia in 1812, the Pennsylvania Company for Insurance on Lives and Granting Annuities was founded. It offered life insurance and annuities to the general public and was the forerunner of modern stock insurance companies.

During the 19th century, the market for annuities grew slowly while that for life insurance

[1] Roy D. Murphy,1939, “Sale of Annuities by Governments” New York: Association of Life Presidents

grew quickly. This disparity in part reflects the different risks that these insurance products address. Individuals who, if they died unexpectedly, would leave dependents in need of income support provide the traditional market for life insurance. Individuals who have no dependents or relatives to provide support if they outlive their resources provide the natural market for annuities. Extended families, common in the 19th century, provided an informal alternative to structured annuity contracts. The falling incidence of multi-generation households in the early 20th century contributed to the growing demand for annuity products. The role of families and other informal arrangements in insuring longevity is cited.[2]

Annuity Market Growth

The annuity business was a small share of the insurance market until the Great Depression. Data compiled by the Temporary National Economic Commission (TNEC) (1941,112) suggest that, over the period 1866-1920, annuity premiums averaged only 1.5 percent of life insurance premiums received by U.S. insurance companies. The Great Depression, and the associated financial panic and bank failures, led many investors to seek reliable investment vehicles for their savings. Individual annuities, many offered by insurance companies with long and sound financial histories, were such vehicles, and they grew rapidly during the 1930s. TNEC (1941) data show that sixty-eight percent of all annuity premiums received between 1913 and 1937 were received between 1933 and 1937. In 1934-36, the premium income on newly issued individual annuities exceeded that on newly issued ordinary life insurance for the 26 large companies studied by the TNEC.

As a share of payouts, reserves, or total premium income, annuities were still a small part of the insurance business in the 1930's. They accounted for 1.79 percent of insurance company disbursements over the 1929-38 period, compared with 24.3 percent for death claims and 23 percent for policy surrender values (TNEC 1941, 324). Annuities, at a.56 percent, accounted for a greater share of premium income during this period, and individual annuities accounted for 80 percent of annuity premiums. In 1938, annuity reserves were $2.67 billion, compared with $16.83 billion in life insurance reserves. Although the annuity market grew rapidly in the 1930's, it represented only a small fraction of the insurance industry at the end of this period. Many firms that had sold policies during that decade subsequently experienced losses on their annuity contracts, for two reasons. First, the rate of return earned on insurance reserves fell during the early 1930's. Long-term interest rates on Moody's AAA corporate bonds averaged 4.68 percent between 1928 and 1932 but 3.45 percent between 1933 and 1940. The real interest rate was much greater than the nominal rate in the early 1930's. The consumer price index fell 20.3 percent between 1928 and 1932, raising the real return to lenders. Long-term interest rates fell below 3 percent in the late 1930's. Because annuities had been sold assuming that prevailing interest rates from earlier periods would remain in force, the drop in rates led to investment earnings below what was needed to service these contracts. Campbell (1969) reports that the net earnings rates of life insurance companies reached a high of 5.05 percent in 1930 but declined for nearly two decades afterward, falling to 2.88 percent in 1947. This was reflected in the poor profitability of annuity contracts. A second factor in annuity losses was the longevity of annuitants relative to the assumptions that insurance companies used in pricing their annuity contracts. Life expectancy did not improve substantially during the

[2] Murphy, 1950, "Significant Annuity Developments" In ed. David Mc Cahan. Life Insurance Trends at Mid-Century 84-99 Philadelphia. U. of Pennsylvania Press

Depression. Life expectancy for white men at age 60 was only 0.2 years longer in 1940 than in 1930. For women, the gain in life expectancy was slightly larger: 0.5 years (*Historical Statistics,* Series B124-125, vol. 1). But as Gilbert (1948) and the TNEC (1941, 331) explain, the mortality tables that life insurance companies used to price annuities were revised several times during the 1930's to reflect the lower mortality risk for annuitants than for the general public. The mortality experience of female annuitants was particularly overstated by the life tables in use at the beginning of the 1930's. Gilbert (1948) compares the 1868 American Experience Table of Mortality, long a standard reference in the insurance industry, and the "expectation" table adopted in 1938 for annuity purposes. The tables show large gains in life expectancy at extreme ages, especially for women. The 1868 table combined both men and women to yield a life expectancy of 8.48 years at age 70. In contrast, the 1938 table shows a life expectancy of 15.62 years for female annuitants at age 70. The overly optimistic mortality assumptions built into annuities sold at the beginning of the 1930's contributed to the losses on these products later in the decade.

The annuity contracts that grew in popularity during the 1930s emphasized the role of annuities as retirement savings and investment vehicles. Annual-premium retirement annuities -contracts that allowed individuals to make premium contributions each year to accumulate a capital fund and then to choose from a number of payout options at the date of their retirement or another advanced age -expanded particularly rapidly. Retirement annuities were attractive retirement saving vehicles for several reasons. They offered returns that were often greater than that available elsewhere for small investors. They provided an option to purchase an immediate single-premium annuity at a future date, typically at terms specified at the beginning of the accumulation period. If the participant decided that was the best way to decumulate assets. Perhaps most important, annuities were supplied by secure financial institutions. Gilbert (1948) notes that even though surrender charges could sharply reduce the return on these products for those who redeemed them before maturity, this did not prevent the rapid expansion of the deferred annuity market in the 1930s.Annuity premiums, the amount an annuitant had to pay to purchase a given payout stream, increased during the 1930s. Gilbert (1948) reports that in 1930 Aetna Life Insurance Company would sell an immediate annual to a 65-year-old man/woman for a premium of $925/1,040. By 1940, the premiums had increased to $1,220/1,435.

The individual annuity market expanded throughout the postwar period and individual annuity premium payments increased almost every year. However, comparing these premium payments with a yardstick for the size of the economy, such as gross domestic product, can be more revealing. Individual annuity premiums were 0.064 percent (six one-hundredths of 1 percent) of GDP in 1951. They declined to 0.053 percent in 1961, then began to increase: to 0.110 by 1971, 0.339 percent in 1981, 0.903 percent in 1991, and to 1.21 percent in 1993. The early 1960s thus marked the beginning of the growth phase for individual annuities, with much of the growth concentrated in the period since the late 1970's.

B. Market Overview

Since 1992, the Gallup Organization has periodically conducted a poll titled ‘Survey of Owner of Non-Qualified Annuity Contracts.’ This section is a synopsis of the information from the 2009 survey. Owners of non-qualified annuities are middle-class individuals who feel confident about their retirement planning. Non-qualified annuity owners are more likely to be female (58%) than male (42%). As evidence that annuities are important retirement savings vehicles, 78% of owners of non-qualified annuity contracts purchased their first annuity when they were less than 65 years of age. Almost all (93%) still own the first annuity that they purchased. Owners of variable annuity contracts tended to purchase their first annuity contracts at younger ages than owners of fixed annuity contracts. 41% of owners of variable annuity contracts were under age 50 when they purchased their first annuity contract. As was true in previous surveys, many owners of non-qualified annuity contracts (69%) are retired. The proportion of annuity owners who are retired is the largest in the history of the survey.

The survey shows that owners of non-qualified annuity contracts have moderate incomes. 80% had incomes below $100,000. Only 4% had annual household incomes above $200,000. Around half (42%) of the owners had household incomes below $50,000. Annual household income is just over $75,000, according to the Gallup survey. Owners of variable annuity contracts have somewhat higher annual household incomes than do owners of fixed annuity contracts. Many Americans recognize that they are responsible for their own retirement, and that annuities are an ideal means of guaranteeing that they will not outlive their resources in retirement. Owners of non-qualified annuities generally believe that they have done a very good job in saving for their own retirement (91% hold this view). However, a significant number of them are concerned that the costs of a catastrophic illness or nursing home care might bankrupt them (50%) or that they might run out of money in retirement (45%). To combat this uncertainty in retirement, 83% of owners of non-qualified annuity contracts plan to use their annuity savings to have as a financial cushion in case they or their spouse live well beyond their life expectancy (83%), to avoid being a financial burden on their children (81%), and for retirement income (76%).

Although a majority of owners of non-qualified annuity contracts believe that the money they will receive from their pensions and other employment-related retirement programs (including Social Security) will be enough to meet their financial needs in retirement, annuity owners also recognize that they must play an important role in saving for their retirement. Of those owners who are not yet retired, 75% expect that their personal savings or pensions (i.e. sources of retirement money other than Social Security) will be a major source of their retirement income. Even those owners who are already retired recognize the role that personal savings play in their financial security in retirement, with over half (51%) citing personal savings or pensions as a major source of their retirement income.

Aside from their non-qualified annuities, owners save through a number of other financial products. The fact that earnings on annuity savings are not taxed until the savings are used remains a strong motivation for purchasing a non-qualified annuity. This tax deferral was cited as a “very important” or “somewhat important" reason for purchasing a non-qualified annuity by 89% of the owners. Additionally, 73% report that they have saved more money than they otherwise would have if the tax advantages of an annuity contract were not available. Nine in ten non-qualified annuity owners (91%) report that they try not to withdraw any money from their annuities before they retire and need the money, because they would have to pay tax on the money that is withdrawn. Almost nine of ten (88%) of owners think that keeping the tax advantage of annuities is a good way of encouraging long-term savings. Despite the importance of the tax treatment to the owners, the other reasons cited as important make clear that annuity owners recognize the unique capabilities of annuity contracts to provide supplemental income in retirement. In fact, 72% of annuity owners believe an important reason for buying annuities is that annuities could provide income guaranteed for life. The most frequently mentioned of the non-tax reasons for purchasing annuities is “it was a safe purchase” (89%). All key demographic groups were in agreement about annuities being a safe purchase, with at least 86% of each believing it is a very or somewhat important reason.

Beside the tax treatment of non-qualified annuities, owners cite a number of reasons as being important in their decision to purchase their contract, the most common of which is that “it was a safe purchase” (89%). Over four-fifths of owners (85%) agree that investment and insurance guarantees are very important benefits of non-qualified annuities. Despite the financial turmoil and market volatility of recent times, owners’ beliefs that annuities are an effective way to save for retirement (86%), are safe and secure (79%), and offer a good return (76%) has remained quite high. Overall, about half (48%) used money from at least one of the following one-time events to purchase an annuity contract: an inheritance (26%), the sale of a home, farm, or business (17%), a death benefit from a life insurance policy (12%), a gift from a relative (13%), or a bonus (7%). Many owners also indicated that some of their annuity premiums came from regular savings (57%), their or their spouse’s current income (45%), or proceeds from an investment (31%).

Forty percent of owners of non-qualified annuity contracts report that the current value of all of the non-qualified annuity contracts owned by themselves or the spouse is less than $100,000, while 12% indicate the account value is less than $25,000. Forty-three percent of owners report that the current value of all of the non-qualified annuity contracts that they or their spouse own is over $100,000, and 23% report that the current value is at least $200,000.

Almost half (45%) of owners of non-qualified annuity contracts are concerned about running out of money during retirement, and 79% believe that annuities are an important source of retirement security. Retirement income remains a key use that owners intend to make of their non-qualified annuities, with 76% of owners saying that they intend to use their annuities for this purpose. Younger owners of non-qualified annuity contracts (those under age 64) are more likely than those who are older to say that they intend to use their annuity savings for retirement income (83% compared to 73% of that age 64 or older). Over 90% of owners of non-qualified annuity contracts “completely” or “somewhat” agree that “annuities are an effective way to save for retirement” (86%), and that "annuities are a good way to ensure your [surviving] spouse has a continuing income” (86%). Those who receive a regular payout from their annuity say that an important reason for purchasing an annuity is that it can provide payments guaranteed to continue for as long as they live (72%).

The survey shows that many Americans are concerned about outliving their savings as they age. Non-qualified annuity owners have made it clear that annuities are an integral part of their retirement savings because only annuities can protect them against outliving their income. As the population ages, the Baby Boomers will continue to focus on their retirement at a time when the stock market and economy is uncertain and when some are questioning the adequacy of Social Security. It is no stretch to conclude that non-qualified annuities are an effective vehicle to ensure their financial well-being in retirement. As a result, the demand for annuity contracts will continue to grow.

Group Plans

The group annuity market, which is linked to corporate defined benefit pension plans, was pioneered by the Metropolitan Life Insurance Company in the early 1920's[3]. Life insurance companies began underwriting group life, health, and disability policies for large corporations in the years after World War I. Providing life annuities to retirees was a natural extension of this business **Most early corporate pensions were financed on a pay-as-you-go basis,** with the firm making payments to beneficiaries from current earnings. Metropolitan introduced its own retirement pension program in 1925 and began actively marketing "group annuities," the name for structured pension programs, in 1927. The group annuity market suffered from the same difficulties as the individual annuity market in the early 1930s, with low investment returns leading to losses on group annuity contracts. This experience, coupled with the passage of the Social Security Act of 1935 (which promised workers a minimal retirement benefit) led to slow growth of group annuities. At retirement, the employee could typically choose between a lump-sum payout of the total contribution and the "paid-up option" in which these contributions were used to purchase a life or joint life annuity. Employer contributions were usually applied to purchase an annuity. The goal of most group annuity plans was to provide, in conjunction with individual benefits from Social Security, a retirement income that replaced roughly 40-60 percent of the retiree's earnings from employment.

Tax-deferred annuity contracts may be written on either an individual or group contract basis. In both cases, the employer must remit the periodic contributions to the insurance company (or custodial account for a mutual fund) after the employee has signed the appropriate "salary reduction agreement" with the employer. Under a group tax-deferred annuity, a participant receives a certificate to indicate participation in the employer's group plan. The employer holds the contract. Under an individual tax-deferred annuity, the individual receives the contract. There is little other difference between the group and individual contracts. Some group contracts may have lower annual fees because a group of individuals are being represented by a single entity (the employer). Individual contracts may be more flexible because the employer has no option to control the contract. In both cases, contribution timing and methods are under the purview of the employer.

[3] James, Marquis 1947 "The Metropolitan Life: A Study in Business Growth." New York: Viking

II The Primary Uses of Annuities

A. Annuities Defined

An annuity is defined as the liquidation of a principal sum to be distributed on a periodic payment basis to commence at a specific time and to continue throughout a specified period of time or for the duration of a designated life or lives.

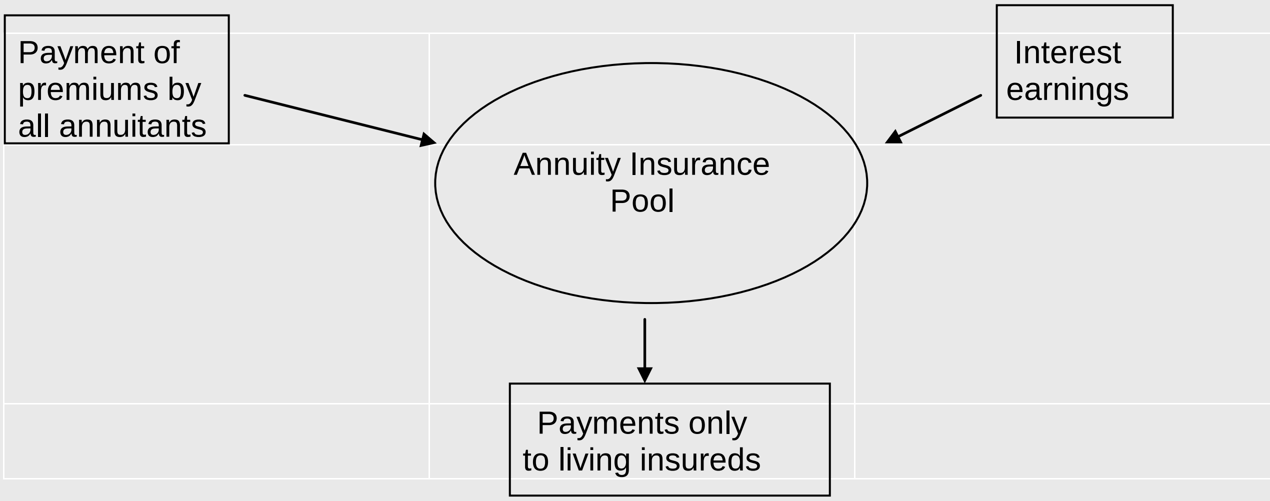
Annuity contracts in the United States are defined by the Internal Revenue Code (IRC) and regulated by the individual states. Variable annuities have features of both life insurance and investment products. In the U.S., annuity contracts may be issued only by life insurance companies, although private annuity contracts may be arranged between donors to non-profits to reduce taxes. Insurance companies are regulated by the states, so contracts or options that may be available in some states may not be available in others. Their federal tax treatment, however, is governed by the IRC. Variable annuities are regulated by the Securities and Exchange Commission and the sale of variable annuities is overseen by FINRA. There are two phases for an annuity, the first phase is when the annuity contract owner deposits and accumulates money into an account (the deferral phase), and another phase in which customers receive payments for some period of time (the annuity or income phase).

What an Annuity Does

An annuity is can be seen as a stream of regular payments. An annuity insurance policy is a contract in which the insurer promises the insured, called the annuitant, a regular series of payments, called rent. The basic insurance principles that underlie an annuity insurance operation are the same as those that underlie all insurance operations. That is, the insurance company combines many individuals exposed to the same peril. It uses the law of large numbers to predict in advance the payments it must make. Then it charges each insured a fair share of all losses. By charging a premium of all the individuals exposed to the peril, the insurance operation transfers money from all the people exposed to the peril to those who will experience the loss.

The "loss" insured against with an annuity is living a long time. This sounds like a loss that most people would not dislike. However, old age without money can be a tragedy. An annuity insurance operation transfers funds from those who die at a relatively early age to those who live to relatively old ages. That is, some annuitants will live to take out much more than they paid in as a premium. Other annuitants will not live long enough to take out as much as they paid in. Every annuitant pays a fair premium to enter the annuity insurance pool. In exchange for the premium, the annuitant obtains the right to receive regular payments from the insurance pool as long as he or she is alive. An insurance company earns interest on all the money in the pool. Therefore, the annuity payments received by an annuitant will come from three sources: (1) liquidation of the original premium payment, or principal, (2) interest earned on the principal, and (3) funds made available by the relatively early death of some annuitants. This concept is illustrated in Figure 2-1.

FIGURE 2-1. The Annuity Insurance Operation



It is interesting to note that the mortality table used by annuity insurers to predict the amount of payments they will make is not the same one used for life insurance calculations. People who purchase annuities live longer than do those who do not purchase annuities. While mortality tables used for life insurance calculations end at age 100, the 1983 individual annuity mortality table and Annuity 2000 mortality table continue to age 115. The reason for this is *adverse selection.*

Adverse selection in life insurance means that those people with a greater than average likelihood of premature death try to purchase life insurance at regular rates. Life insurers try to prevent adverse selection by requiring medical examinations in addition to other underwriting precautions. It is more difficult to prevent adverse selection by people purchasing annuities. Theoretically, an insurer could require a medical examination and then reject the "superhealthy" as "poor risks." However, this generally is not a sound approach to take with the public. Therefore, the insurer recognizes that people who purchase annuities are probably in above-average health. This explains why they use a mortality table that reflects this better than average mortality. Annuities offered by insurance companies are usually priced to cover operating costs and costs of adverse selection.

Retirement Yesterday

To appreciate the difficulty of giving up work and entering retirement, one must first understand the paradigm shift that has occurred since the contemporary concept of retirement began. Historically, workers worked until they couldn't work anymore. The age 65 metric is a relatively recent addition to the retirement requirement. As Germany consolidated into one nation and industrialized, this somewhat arbitrary age picked was chosen by German Chancellor Otto von Bismarck for one of the first retirement plans in the mid-1800s. What was the average life expectancy in the mid-1800s? It was in the mid-40s. So, in order to realize retirement benefits, workers had to outlive their life expectancy by approximately 50 percent. When the Social Security Act was created in the 1930s, life expectancy had jumped to about 62, according to the Social Security Administration. It was an actuarially flawless plan; the average person would not live long enough to realize any benefits from the program. It was designed to take care of those few people who, in effect, lived too long to work. With the economic expansion in full swing just a decade later in post-World War II America, there were tremendous inflationary pressures. Federal wage controls were instituted to prevent workers from being poached by other companies with higher wages. Employers needed a new value proposition to offer prospective employees: "If you put 20 years on the clock, I will pay you not to work here any longer." Thus, modern corporate pension plans came into being. It was a pretty safe bet most workers would not make it to retirement age anyway, and if they did, they'd only have a few years left to enjoy their retirement. The difference today is that Americans have much greater longevity. By the standards of yesterday, retirement benefits would not be offered in this day and age until around age 90.

B. Utilization of Annuities

How does the utilization of annuities help fulfill consumer's retirement goals as compared to other financial planning vehicles? This section examines how annuities stack up versus certificates of deposit, mutual funds, bonds, savings accounts, etc. The term "annuity," as used in financial theory, is most closely related to what is today called an *immediate annuity*. The overarching characteristic of the immediate annuity is that it is a vehicle for distributing savings with a tax-deferred growth factor. A common use for an immediate annuity might be to provide a pension income. In the U.S., the tax treatment of a non-qualified immediate annuity is that every payment is a combination of a return of principal (which part is not taxed) and income (which is taxed at ordinary income rates, not capital gain rates). Immediate annuities funded as an IRA do not have any tax advantages, but typically the distribution satisfies the IRS required minimum distribution requirement and may satisfy the required minimum distribution requirement for other IRA accounts of the owner (IRC Sec 1.401(a)(9)-6.). When a deferred annuity is annuitized, it works like an immediate annuity from that point on, but with a lower cost basis and thus more of the payment is taxed.

Phased Withdrawal vs. Fixed Payout

Financial advisers have developed standardized payout strategies to help people manage their money in their retirement years. Prominent among these are *phased withdrawal* plans offered by mutual funds including the “self-annuitization” or default rules encouraged under US tax law, and *fixed payout* annuities offered by insurers. To have enough for retirement, workers must first choose which payout strategy to employ for a wide range of risk aversions.

The annuitization option assures a lifelong consumption stream that cannot be outlived, but at the expense of a complete loss of liquidity. On the other hand, in self-annuitization, discretionary management and consumption from assets preserves flexibility, but with the distinct risk that a constant standard of living will not be maintainable. A retiree who decides to forego the life annuity and instead withdraw a fixed periodic amount from wealth will find it difficult to compete with the very high “mortality credits” at advanced ages.

The life annuity gives the retiree a constant income stream as long as he or she lives. When self-annuitizing, the retiree invests his or her money in an investment fund and periodically withdraws money to finance needs. This gives the retiree more flexibility in structuring his or her consumption stream, but exposes the retiree to individual longevity risk. Thus, on the one hand, the retiree may outlive his or her financial resources by living longer than expected and/or by poor mutual investment fund performance (shortfall risk). On the other hand, the retiree may be able to bequeath substantial wealth.

Dependent on asset allocation or annuity purchase age, it is possible to minimize but never to fully eliminate shortfall risk. In other words, there is no easy arbitrage possibility in the annuity market. From a retiree's viewpoint, knowing the shortfall risk magnitude is not very helpful in making investment decisions. However, it is not easy to clearly see the entire chance and risk profile of the self-annuitization strategy, because information about the utility of the bequest may be necessary to evaluate the chances.

The simplest form of life annuity is a bond-like investment with longevity insurance protecting the retiree from outliving his or her resources, guaranteeing lifetime level payments to the annuitant. Insurers hedge these contracts by pooling the longevity risks across a group of annuity purchasers. Standard economic theory teaches that life annuities will be valued by risk-averse retirees, inasmuch as these contracts provide a steady income for life and hence they protect the retiree against the risk of exhausting her assets. Economic theory maintains that the retiree maximizing a time separable utility function without a bequest motive would buy annuities with all his or her wealth, given a single risk-free asset and facing actuarially fair annuities. Yet available evidence from most countries indicates that very few retirees actually purchase annuities with their disposable wealth.

Efforts to explain this so-called "annuity puzzle" have noted some disadvantages of annuitization; for example, buyers lose liquidity because the assets usually cannot be recovered even to meet special needs. The presence of a bequest motive also reduces retiree desires to annuitize wealth. Other explanations for why people may be reluctant to buy annuities include high insurance company loadings; the ability to pool longevity risk within families; asymmetric mortality expectations between annuity buyers and sellers; and the existence of other annuitized resources such as Social Security or employer-sponsored pensions. In addition, annuities can appear relatively expensive depending on the interest rate environment, as compared to equity-based mutual fund investments. Also, many payout annuities sold by commercial insurers are fixed in nominal terms, so inflation erodes the value of the stream of payments. The annuity purchaser also misses out on gains in stock market performance.

Another reason people may not annuitize is that they believe they will do better by continuing to invest their retirement assets, making withdrawals periodically over their remaining lifetimes. Doing this is not so simple, however, as the retiree must select both an investment strategy- how much to invest in stocks and bonds- and a withdrawal rate, spelling out how much of their balance to spend per year. Financial advisors often recommend "rules of thumb," for instance dividing the portfolio roughly 60% stocks/40 % bonds and a spending rule of 4-5% of the balance per year. Compared to buying a fixed life annuity, such an investment-linked phased withdrawal strategy has several advantages;

- It provides greater liquidity
- Participation in capital market returns
- Possibly higher consumption while alive
- The chance of bequeathing assets in the event of early death.

Too Much Like Work
Yet a phased withdrawal tactic also exposes the retiree to investment risk and it offers no longevity pooling, so the retiree could possibly outlive his or her assets before an uncertain date of death. Thus any withdrawal plan which includes some risky investments and also requires the retiree to draw a fixed amount from the retirement account each period. This involves a strictly positive probability of hitting zero before the retiree dies. The risk of running out of money can be partially mitigated by linking the drawdown to the fund balance each period, though of course this will produce benefit fluctuations which might fall substantially below what the life annuity payment would have been. Besides, not many people want to expend the effort to become wealth accumulation wizards. Consider this paragraph;

> Prior studies have compared the pros and cons of specific phased withdrawal plans with life annuities that pay fixed benefits. For instance, some authors calculate the probability of running out of money before the retiree's uncertain date of death, using assumptions about age, sex, capital market performance, and initial consumption-to-wealth ratios. These analyses also show how an optimal asset mix can be set to minimize the probability of zero income. Follow-on works extended this research by quantifying risk and return profiles of fixed versus variable withdrawal strategies using a shortfall framework. On the return side, that study quantified the expected present value of the bequest potential and the expected present value of benefit payments; conversely, it measured the risk as the timing, probability, and magnitude of a loss when it occurs, compared to a fixed annuity benchmark.

What is the likelihood of getting a prospective client to read or comprehend this, even without getting a handle on the implied math calculations?

Planning Characteristics

Comprehensive financial planning has taken on many characteristics over the past decade as a result of economic changes. Retirement planning is an uncertain avocation that the average working person gets to do but once. It calls for well thought out and decisive action. Too often people delay taking important actions because of external circumstances. An advantage of annuities is that none, part or all of a current paycheck can be socked away for retirement.

Before any retirement planning decisions are made, future retirees must first create clear objectives or outcomes. Knowing how to fulfill retirement intentions begins with knowing what the intentions are. People must go through a self guided, self-actuated discovery process as the foundation for creating wise decisions and producing confident results. The process allows people to take the uncertainty out of their future and to be more intentional with wealth. Workers must ask of themselves what is important to them; not only for them, but for their families as well. This conversation must be conscientiously and doggedly pursued with the man or woman in the mirror on a periodic basis. The agent is reminded that the purpose of these mental inquiries for the client is to encourage individuals to reflect upon what they value most and what they intend to achieve as far as retirement is concerned. After helping clients develop a more complete knowledge of the ideas and objectives that are central to their lives. As the Gallup survey point out, most people's goals are simple; not to outlive their means and perhaps to be able to leave a legacy to their children. Annuities fill this bill.

U.S. workers face a number of risks in both accumulating and preserving pension benefits. Specifically, workers may not accumulate sufficient retirement income because they are not covered by a defined benefit or defined contribution pension plan. For example, according to national survey data, about half of the workforce was not covered by a pension plan in 2008. Furthermore, workers covered by defined contribution plans, in particular, risk making inadequate contributions or earning poor investment returns, while workers with traditional defined benefit plans risk future benefit losses due to a lack of portability if they change jobs. Preretirement benefit withdrawals (leakage), high fees, and the inappropriate drawdown of benefits in retirement also introduce risks related to preserving benefits, especially for workers with defined contribution plans.

Key Risks in Accumulating and Preserving Retirement Benefits

Workers’ career						Retirement
$ Accumulation $ $ $ $ $			**$$$$$ Preservation**			$Liquidation$
Lack of coverage	Insufficient contributions	Poor investment Returns	Lack of portability	Leakage	High fees	Inappropriate drawdown of benefits

Pension plans offered by private employers in the United States operate in a voluntary system with tax incentives for workers to participate in plans that employers offer. Employers may choose to offer different types of plans which fall into two broad categories: defined benefit and defined contribution. A defined benefit plan is generally financed by the employer and typically provides retirement benefits in the form of an annuity that provides a guaranteed monthly payment for life, the value of which is determined by a formula based on salary and years of service. Defined benefit plans offer benefits in the form of an annuity; however, a defined benefit plan may also provide workers the option of receiving their benefits as a lump sum distribution.

Defined benefit plans can include hybrid plans, such as cash balance plans. Cash balance plans are referred to as hybrid plans because legally they are defined benefit plans but contain certain features that resemble defined contribution plans. As with traditional defined benefit plans, employers that sponsor a cash balance plan make contributions to a pension trust fund that is invested on behalf of the employees in the plan. However, unlike traditional defined benefit plans that express retirement benefits as an annuity amount calculated using years of service and earnings, cash balance plans express benefits as a hypothetical individual account balance that is based on pay credits (percentage of salary or compensation) and interest credits, rather than an annuity.

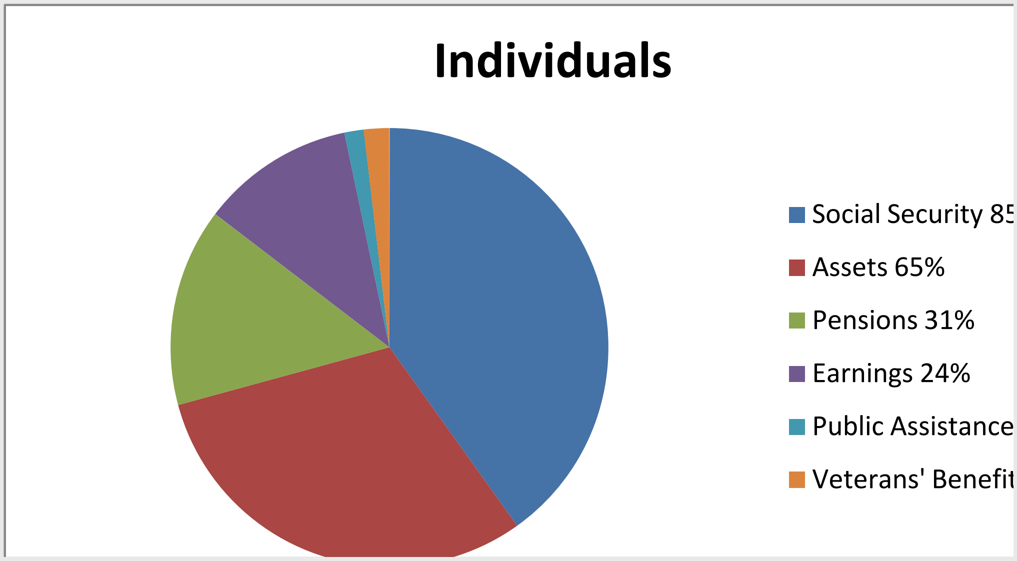
In a defined contribution plan workers and/or employers make contributions into individual accounts set up for each participant. Most defined contribution plans allow participants to direct these contributions to mutual funds and other financial market investments to accumulate pension benefits, dependent on net investment returns, which will then be withdrawn during retirement. Over the last two decades, the number of defined benefit plans has declined substantially while the number of defined contribution plans has increased. In 2007, about half of private sector workers participated in employer-sponsored pension plans; 21 million had a defined benefit plan and more than 40 million had a defined contribution plan. Research suggests that retirement income from pension plans is likely to be inadequate for many workers in the United States. In recent years, a considerable number of defined benefit plans have been terminated or closed to new participants, which prevents workers from accruing further benefits in those plans in most cases. For those with defined contribution plans, data gathered before the recent financial crisis indicate that many workers have low balances.

Data indicates that in 2017 the average balance in 401(k) plans was $167,700 for individuals aged 60-69.[4] In periods of poor investment returns (such as 2007-2009) losses in workers' defined contribution plans leave them at a greater risk for having inadequate savings for retirement.

In addition to pension plans, retirees depend on other sources of income in retirement. Social Security benefits provide the largest source of retirement benefits for most households. In 2015, Social Security benefits provided over 50 percent of total income for 55.9 percent of households with a family member age 65 or over. Social Security benefits provided over 90 percent of total income for 24.7 percent of households with a family member age 65 or over (SSA, *Income of the Aged Population)*.

<u>Figure 2-2: Sources of Income for Households Aged 65 and Older</u>

Percentage of adults 65 and older receiving income from specified sources in 2016



Source: U.S. Social Security Administration, Office of Retirement and Disability Policy, *Income of the Population 55 or Older*, 2016.

Note: Data reported by the Social Security Administration for pension income includes regular payments from IRAs, Keogh, or 401(k) plans. Nonregular (nonannuitized or lump-sum) withdrawals from IRA, Keogh, and 401(k) plans are not included as income.

Replacement Rate

As seen in Figure 2-2, income from other sources, such as asset income (e.g., interest and dividends) and earnings from working during retirement are also important for households aged 65 and older. (Asset income includes income from interest, dividends (from stock holdings and mutual fund shares), rent, royalties, and estates and trusts. Sources of asset income may include IRAs and other savings. Capital gains from the sale of stock are not included as income.)

[4] Fidelity, 2017

There is little consensus about how much constitutes “enough” savings for retirement. Retirement income adequacy may be defined relative to a standard of minimum needs, such as the poverty rate, or to the level of spending households experienced during working years. Some economists and financial advisors consider retirement income adequate if the ratio of retirement income to preretirement income—called the replacement rate—is between 65 percent and 85 percent. The replacement rate generally refers to the ratio of retirement income to preretirement income, but specific calculations of replacement rates can vary. For example, the measure of preretirement income could be based on final pay or a longer term average of pay. Retirees may not need to replace 100 % of preretirement income to maintain living standards for several reasons. For example, retirees will no longer need to save for retirement and their payroll and income tax liability will likely fall. However, some researchers cite uncertainties about future health care costs and future Social Security benefit levels as reasons to suggest a higher replacement rate may be necessary.[5]

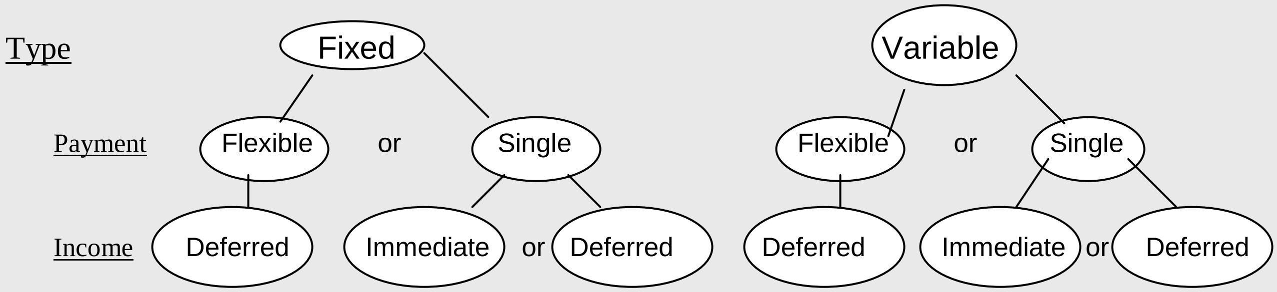
Data from the Social Security Administration (SSA) shows that 61% of retired workers count on their benefits to provide at least half of their monthly income. For unmarried elderly individuals this figure jumps to 71%.
Yet according to the SSA, Social Security benefits are only truly designed to replace about 40% of the average worker's wages during retirement. Based on the $1,363.66 that the average retired worker receives each month (as of Feb. 2017), or $16,364 a year, this means around $24,000 in additional annual income (approximately 60%) should be derived from other sources aside from Social Security (e.g., a pension, 401(k), IRA, or some other retirement or investment account).

[5] J Skinner, “Are You Sure You’re Saving Enough for Retirement,” *Journal of Economic Perspectives*, vol. 21, no. 3, Summer 2007, 59-80

III Types of Annuities

An annuity is defined as the liquidation of a principal sum to be distributed on a periodic payment basis to commence at a specific time and continue throughout a specified period of time or for the duration of a designated life or lives. Chart II A illustrates the types of annuities and their payment method.

Chart III A



A. Annuity type, when benefits are paid

1. Immediate Annuity

If a person pays for an annuity and the benefits begin after a relatively short delay, this is described as an immediate annuity. An immediate annuity contract is a single premium contract providing substantially equal annuity payments that start within one year from the date of purchase and are paid at least annually. In the case of the single-premium immediate annuity, there is no accumulation phase

2. Deferred Annuity

If a person pays for an annuity and benefits do not begin at once, this is a deferred annuity. A single-premium deferred annuity, for example, includes a waiting period between the premium payment and the beginning of annuity payouts. The promised stream of payments for a given premium is greater for a single-premium deferred annuity than for a single-premium immediate annuity, since the premium is invested and earns returns between the date when it is paid and the date when the payouts begin. A variant on such an annuity, one that provides for multiple premium payments, could represent a saving plan for an individual who plans to use an annuity to draw down accumulated resources. The income on assets held in a deferred annuity account is not taxed until the payout phase, which can be many years after the income accrues. Annuities therefore afford and opportunity for asset accumulation at the pre-tax rate of return.

3. Immediate vs. Deferred Annuity

In an immediate annuity, payments begin to the buyer immediately (with a year) upon purchasing the contract. An immediate annuity is used when an investor needs to have a consistent income stream from a lump sum investment. A deferred annuity delays payments to the buyer until a future time -- at retirement for example. The money invested in the contract grows during this deferred period. (This is called the "accumulation" period.) A deferred annuity is appropriate for someone wanting tax deferred growth on their assets.

When to Buy an Immediate Annuity Immediate annuities provide a guaranteed stream of income payments for the rest of an individual's life or for a specific period of time selected at the time of purchase. Making a one-time contribution purchases an immediate annuity. Payments from the annuity begin within the first year after purchase.

An immediate annuity should be considered by a prospective purchaser if:

- He or she has a lump sum of money and need to start receiving dependable income
- The purchaser needs an immediate return from their investment
- The annuitant wants to receive a steady monthly check for the rest of his or her life

Remember that immediate annuity payments often maintain the same dollar amount throughout the life of the payment terms.

When to Buy a Deferred Annuity- Deferred annuities allow money to accumulate over time and grow tax-deferred several years before the start of payments. Deferred annuities are designed for long-term savings, such as retirement. When someone starts receiving income from their deferred annuity, there are several payment choices available, similar to the options available in an immediate annuity. Deferred annuities may have withdrawal charges that apply if the annuitant decides to take money out in the first few years of the contract. There are usually provisions that allow access to a small percentage funds in case of unforeseen need.

A deferred annuity should be considered by a prospective purchaser if:

- An individual wants to save for retirement and enjoy tax-deferred growth
- He or she already contributes the maximum to a 401(k), TSA, IRA or other retirement plan and still wants to save more for retirement
- The person is self-employed or own a business and needs to set up a retirement plan

Deferred annuities can be part of an employer-sponsored retirement plan or an IRA account, but can also be used as an additional means of saving for retirement or funding other long-term savings goals.

B. Annuity type, how and when premiums are paid

1. Single premium annuity

When only a single deposit is allowed and no future deposits can be made. The original lump sum will begin to grow based on the provisions agreed upon issuance. Money will build inside the annuity on a tax-deferred basis, and cannot be accessed until the annuitant attains age 59 1/2 without penalty. After that point, only earnings are taxed, the original principal is returned on an after-tax basis. Since there was no income tax deduction on the original deposit, it is returned income tax-free. If partial withdrawals are taken from an annuity, a portion of each payment may be considered return of principal, and a portion considered interest. In this case, an "exclusion ratio" as prescribed in the IRS tax codes applies to calculate the taxable portion.

2. Flexible premium annuity

Flexible Premium Annuities are issued by insurance companies who allow varying premium deposits after satisfying an initial minimum premium payment. A person may deposit as little (within company minimums) or as much from that point on as desired. The money will build inside the annuity on a tax-deferred basis, and cannot be accessed until age 59 1/2 without penalty. After that point, only earnings are taxed, the original principal is returned on an after-tax basis. Again this is because there was no income tax deduction on the original deposits. Partial withdrawals from an annuity can cause a portion of each payment to be considered return of principal and a portion considered interest. The exclusion ration applies in this case as well.

3. Single Premium vs. Flexible Premium

A single premium annuity is purchased with a single payment. Flexible premium contracts are purchased with a minimum down payment and subsequent payments to be made at the discretion of the investor. Flexible premiums are usually associated with deferred annuities as they give the investor the chance to add to the contract over numerous years.

C. Annuity type, investment options offered

1. Variable annuity

A variable annuity can be purchased by making either one or a series of payments. A variable annuity offers a range of investment options. The value of the investment will vary depending on the performance of the investment options chosen by the annuitant. The investment options for a variable annuity are typically mutual funds that invest in stocks, bonds, money market instruments, or some combination of the three. Although invested in mutual funds, variable annuities differ from mutual funds in several important ways;

- They provide periodic payments for life or an agreed-to time span (or the life of a spouse or some other designated person).
- A death benefit is offered. If the annuitant dies before the insurer has started making payments, a beneficiary is guaranteed to receive a specified amount – typically at least the principal amount.
- Variable annuities are tax-deferred. No income tax is paid on investment gains until money is withdrawn. Money can also be transferred from one investment option to another without penalty. That means an individual pays no taxes on the income and investment gains the annuity until the money is withdrawn. A person may also transfer his or her money from one investment option to another within a variable annuity without paying tax at the time of the transfer. When money is taken out of a

variable annuity, however, tax will be levied on the earnings at ordinary income tax rates rather than lower capital gains rates. In general, the benefits of tax deferral will outweigh the costs of a variable annuity only if it is held it as a long-term investment to meet retirement and other long-range goals.

2. Fixed Annuities

The annuitant receives a definite amount at regular intervals for a specified length of time, including the remaining lifetime of the annuitant. Fixed-dollar benefits mean that the number of dollars that the annuitant receives as each regular payment stays the same. Thus, a $600 a month annuity provides $600 a month for as long as the insurer promised.

3. Indexed Annuities

Indexed annuities, also called equity indexed annuities, are a newer type of retirement income that combines the best qualities of a fixed annuity with the greater income potential of a variable annuity. Indexed annuities' gains are based on the performance of certain indexes, such as the S&P 500, Dow Jones Industrial Average or others. They are like traditional annuities in that a premium payment is made to an insurance company and then the contract holder receives monthly, quarterly, or annual payouts. Indexed annuities offer a minimum fixed rate, so even in periods of poor index performance a certain rate of return is guaranteed. The payout is slightly different with indexed annuities. A person can choose to have a guaranteed income for life, but upon death, beneficiaries will receive the remaining value of the account. The value is determined by average index earnings on the death date or in some cases the anniversary of the creation of the annuity.

4. Fixed vs. Variable vs. Indexed

Fixed Annuity Considerations- Fixed annuities offer tax-deferred growth. The earnings on a contract will not be taxed until they are withdrawn. That means the capital that would ordinarily go to the tax collector will instead accumulate interest for the annuity owner. Over the life of the contract, that tax deferral can make a significant difference in earnings. Fixed annuities offer a fixed rate of return. The rate of return is known at the beginning of each period. Also, fixed annuities offer a death benefit. If the annuitant dies before payout, his or her beneficiaries will receive all the purchase payments plus any accumulated earnings.

Variable Annuity Considerations- Variable annuities offer many of the same benefits as fixed annuities, including tax-deferred growth and a death benefit. Unlike fixed annuities, however, the owner controls where the value in the contract will be invested. Within the limits of the investment divisions, the owner can be as aggressive or as conservative as he or she wants. This gives a variable annuity the potential for higher returns than a fixed annuity. This potential for higher returns requires the assumption of a greater risk of loss.

Equity-Indexed Annuity Considerations- Equity-indexed annuities, either immediate or deferred, earn interest or provide benefits that are linked to an external equity reference or an equity index. The value of the index might be tied to a stock or other equity index. One of the most commonly used indices is Standard & Poor's 500 Composite Stock Price Index (the S&P 500), which is an equity index. The value of any index varies from day to day and is not predictable. When an equity-indexed annuity is purchased, and insurance contract has been bought- not shares of any stock of index.

Currently-Available Annuity Products in the United States

Virtually all of the annuity products marketed to individual annuity buyers in the U.S. are nominal annuities. They pay benefits that are not inflation-indexed. Two forms are common:

(a) level-payout annuities that provide a fixed payment, typically monthly, for as long as the annuitant is alive; and

(b) graded annuities paying benefits that increase over time at a pre-specified rate (e.g. at three or five percent per year).

The payout streams associated with these two types of policies differ, with the real value of payouts from a level-payout nominal policy declining faster than that from a graded annuity. A graded annuity does not offer inflation protection, of course, since the stream of benefits provided is not affected by the inflation rate over the contract's lifetime. An annuity may be purchased as either an individual policy or a joint-and-survivor policy. In the former case, benefit payments continue as long as the insured person is alive. In the latter case, benefits are paid for as long as either of two individuals is alive. Joint and survivor products vary in the ratio of the payout that second-to-die annuitant receives, relative to the payout when both annuitants are alive[6]. There are three common types of joint-and-survivor products (and several variants). One of the common types, a "100 percent survivor policy," provides the same benefit when both members of a couple are alive as when only one survives. A related policy, a "50 percent survivor policy," provides the survivor with half of the benefit that was paid when both annuitants were alive. The third common policy is a "50 percent contingent beneficiary policy." In this case, one of the annuitants is defined as the primary and the other as the contingent beneficiary. The full amount of the annuity payout continues for as long as the primary beneficiary is alive, even if the primary beneficiary outlives the contingent beneficiary. If the primary beneficiary predeceases the contingent beneficiary, the contingent beneficiary receives a payout equal to half of the primary beneficiary's payout.

A final factor affecting annuity products is their tax status, which has to do with the source of the funds used to purchase the annuity. In the U.S., contributions to employer-provided pension programs are subject to tax preferences as long as the plan meets regulatory standards.[7]

D. Relationship Between the Annuity Types

Agents must be able to distinguish the relationship between the annuity types reviewed in A (payout), B (premium), and C (investment) above; and how they relate to clients. There should be no mystery as to how the annuity contract operates. When a consumer purchases a financial product, he or she "buys in" to a commitment– in this case an

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[6] Brown and Poterba, 2000, "Joint Life Annuities and Annuity Demand by Married Couples" *Journal of Risk and Insurance* 67(4) 527-554

[7] McGill, Brown, Haley, and Schieber, Fundamentals of Private Pensions, 7th ed., Pension Research Council, U. of Pennsylvania, 1996, summarizing the regulations that govern qualified plans. Brown, Mitchell, Poterba, and Warshawsky 1999, "New Evidence on the Money's Worth of Individual Annuities" *American Economic Review*, 89(5) 1299-1318, analyze the tax treatment of distributions from qualified and nonqualified plans.

annuity– and more specifically a particular type of annuity chosen by the client; one that will fit the consumer's needs for a long time. Rules, regulations, and covenants are already in place when a prospective purchaser decides to buy. The prospective owner receives important documents describing financial aspects of the particular product, insurance carrier information, and copies of pertinent documents. The new owner not only buys in to a product, but also makes a financial obligation. Agent documentation of all aspects of the transaction is beneficial should future questions arise.

IV Parties to an Annuity

A. Rights and Obligations of the Annuity Owner

The person who purchases the annuity is the owner. The Owner may be more than one individual, or an annuity can be held by a person that is not a natural person, such as a corporation or a trust (special rules apply for “nonnatural” Owners). The Owner may also be the Annuitant or the Beneficiary. There is no limit to the number of Owners on any one contract.
The Owner has the following rights during the lifetime of the Annuitant:

- The right to designate the Annuitant.
- The right to designate the Beneficiary.
- The right to designate the Annuity Payout Starting Date.
- The right to designate the Settlement Option.
- The right to make early withdrawals or surrender the Annuity.
- The right to make an assignment or name another Owner.

For IRA, Keogh and teacher salary reduction plans the Owner and Annuitant have to be the same individual.

1. Entities Eligible for Annuity Ownership

The owner of an annuity is the party who pays the premiums for the contract. The owner of a nonqualified annuity is the person with total control of the contract prior to the annuitant’s death. During the annuitant’s lifetime and before the maturity date, the owner may exercise any of the rights listed above. In most instances, the owner will be one person, the person whose money buys the contract. Other forms of ownership may be desirable in limited circumstances.

Joint ownership was more common in the past than today. Previously, a parent, age 50, might buy a deferred annuity with a child, age 25, as the joint owner and annuitant. The parent set the maturity date at the annuitant’s 85th birthday. The child owned the contract after the parent’s death and income tax deferral of up to 60 years was possible.

The Tax Reform Act of 1986 amended Inter Revenue Code (IRC) Section 72(s)(1) to require annuity contracts be distributed within five years. The law effectively disallows long periods of tax deferral through joint ownership arrangements.

Joint ownership and taxes- A joint annuity is a joint tenancy with right of survivorship. The arrangement has many ramifications. Signatures of both owners are required to make a policy change or accomplish a partial or total surrender. Distribution checks are payable jointly. Two 1099 forms are sent, one to each joint owner for one-half of the total distribution.

Joint ownership also may cause adverse gift and estate tax consequences. If a party purchases a joint annuity and contributes the entire premium, there is a taxable gift of one-half of the premium to the other owner. At the first owner's death, the contract's entire value will be included in the gross estate unless it is proved the survivor contributed to the contract. A special rule applies to married couples; one-half of the value is included in the estate of the first owner to die regardless of actual contribution.

Ownership by other than a natural person- Sometimes the prospect wants the annuity owned by a "non-natural owner," for example, a corporation or trust. Under IRC Section 72(u), the contract loses its tax deferral if a non-natural person owns it. The credited interest is reported as taxable income to the owner each year, which usually is not desirable. On the other hand, an annuity held by a trust as agent for a natural person is considered as owned by a natural person and therefore retains its tax-deferred status. A living trust may own a nonqualified annuity; this is not recommended for a married couple. As described above, if one spouse is the annuity owner and the other spouse the beneficiary, the beneficiary spouse may continue to defer taxation of the credited interest upon the owner spouse's death. If the policy is owned by a living trust, immediate taxation of the interest or other earnings usually cannot be avoided.

Ownership by a minor- Often, a parent or grandparent wants to purchase an annuity for a child's education with the minor child as owner. The transaction must accord with the applicable state's Uniform Gift to Minors Act (UGMA) or Uniform Transfers to Minors Act (UTMA). An adult custodian is chosen; the ownership designation is "Jane Smith, custodian for Joe Smith, a minor, under the California Uniform Transfers to Minors Act." Although the owner is an adult custodian, the child's Social Security number is used. The annuitant is the child and the beneficiary is the child's estate.

Contingent ownership- The selection of a contingent owner is important if the owner is not the annuitant. The death of an annuitant causes the immediate maturity of the contract. The annuity ceases to exist; all that is left is the death proceeds payable to the beneficiary. Conversely, when the owner dies but the annuitant still lives, the contract continues, but with a new owner. If an owner dies before the annuity starting date, IRC Section 72(s) requires the contract be distributed within five years. This five-year distribution rule does not apply if the spouse is the new owner.

2. Rights of Annuity Owner in Owner-Driven Contract

Before proceeding further it is important to understand three concepts that directly affect annuity contract structuring surrounding the event of death:

- **The Death of the Holder Rule** states that upon the death of a holder, death benefits of the annuity must and will be paid out. The "holder" is synonymous with the taxpayer/owner in any contract.
- **In the case of a non-natural trust-owner,** the annuitant is considered the owner, but only for death distributions. The IRS enacted these contract provisions after January 18, 1985 to prevent generational tax skipping. After April 22, 1987, the provision became applicable to "any holder."

- **The Spousal continuation Rule [IRC 72(s)]** states that the deceased owner's surviving spouse can become the contract owner. The surviving spouse can then continue the contract throughout his or her lifetime and is not forced to take a distribution. If anyone else is named as a primary beneficiary along with the spouse, the option of the surviving spouse becoming the contract owner can be lost.

In cases where a child and spouse are named as primary beneficiaries, some companies will allow spousal continuation but only on the spouse's remaining portion of the contract. The IRC states only that the beneficiary be a spouse; however, some contracts specify that the spousal election letter will only be sent out if the surviving spouse is the "sole" beneficiary, which is a narrower interpretation of IRC. Death benefits can come in two forms:

1. The assets that have accumulated in the annuity investment itself, or,
2. Enhanced death benefits provide the potential of greater payouts based on certain contract guarantees. The enhanced death benefits feature offers another advantage over many other types of investments.

Owner-Driven- All annuity contracts are currently "owner-driven" in the sense that, under current law, the death of an owner requires a payout of an annuity, regardless of whether an annuitant is alive. Likewise, the death of an annuitant in most contracts currently issued (annuitant-driven) also requires a payout, per the terms of the annuity. It is the Internal Revenue Code that requires the payout at the death of the owner. The payout at the death of an annuitant is per the terms of the contract; it is the company's determination of whether there will be a payout at the death of the annuitant. Under an owner-driven contract, only the death of the owner triggers the guaranteed death benefit. Here is an example:
Owner-Driven Contract
Owner: Husband
Annuitant: Wife
Beneficiary: Children
Original Deposit/Guaranteed Death Benefit: $750,000
Current Value: $400,000

Now, if the wife dies, the husband is generally able to name another annuitant without a payout or any other consequences. He simply names another annuitant. There is no step up in the value of the contract though, because it is owner-driven, and the owner did not die.

On the other hand, if the husband dies, then the contract must pay out, even though the wife/annuitant is still alive. Furthermore, since it is an owner-driven contract, the guaranteed death benefit applies. In this case, the children will have a death benefit of $750,000 to for which to select a distribution option.

3. Rights of Annuity Owner in Annuitant-Driven Contract

An annuitant-driven means that the contract requires a payout at the death of the annuitant. It is worth noting that there is another substantive point on how annuitant-driven contracts work. It determines when the guaranteed death benefits are applicable**.** In an annuitant-driven contract, generally only the death of the annuitant will trigger the guaranteed death benefit (as opposed to the standard death benefit, the current value).

As mentioned above, under an owner-driven contract, only the death of the owner triggers the guaranteed death benefit. Here is an annuitant-driven example:

Annuitant-Driven Contract
Owner: Husband
Annuitant: Wife
Beneficiary: Children
Original Deposit/Guaranteed Death Benefit: $750,000
Current Value: $400,000

If the husband dies, the contract must pay out, per the IRC. However, because the contract is annuitant-driven (and the annuitant/wife is still alive), the standard death benefit of the current value is paid out. Therefore, the children will receive the current value of $400,000 (despite the fact that the annuitant/wife is still alive) for which they must select a distribution.

If the wife dies, then the contract must pay out. Furthermore, because the contract is annuitant-driven, and the wife/annuitant has died, the guaranteed death benefit of $750,000 is payable. However, the death benefit is paid to the children, as primary beneficiaries. Since the husband is still alive, but the children have received the proceeds, this may be deemed a taxable gift from the husband to the children of $750,000 at the death of the wife.

B. Rights and Obligations of the Annuitant

The annuitant is often characterized as the ‘measuring life’ under an annuity because the duration of the annuity payments made by the issuer (or the payment of a death benefit before annuity payments begin) may depend on how long the annuitant lives. His or her life measures the benefits under the contract.

1. Entities Eligible for Role as Annuitant

The annuitant is the person who receives annuity benefits at the contract maturity date. The annuitant is always an individual; it cannot be an unnatural person. The annuitant typically has no rights under an annuity contract. Upon the annuitant’s death, the contract matures automatically and the cash value is paid to the designated beneficiary. The annuitant can be the same person as the owner. Naming an annuitant other than the owner exposes the owner to two risks: first, the annuitant may predecease the owner, which causes contract maturity and distribution of cash value to the named beneficiary; second, the annuity benefits will be paid to the annuitant, not the owner, on the annuity starting date. Few companies accept joint annuitants. In any event, there is no reason to use this designation. Naming an annuitant other than the owner is justified only if the proposed owner is older than the maximum age permitted by the insurance company, age 75 years, for example. If the proposed wants to own an annuity, he or she must name some younger annuitant, such as a child.

2. Role of Annuitant in Owner-Driven Contracts

By “driven” it is meant that certain actions occur upon death that are beyond the control of named parties to the contract. In an Owner Driven contract, owners have all legal rights, and can change the designated annuitant as needed without any negative tax or penalties, as the contract specifies. Owner Driven contracts pay out only upon the death of the owner.

3. Role of Annuitant in Annuitant-Driven Contracts

In an Annuitant-Driven contract, owners can usually be changed. It is contract specific as to whether an annuitant can be changed once the contract is issued. Also, the contract will pay out upon the death of either the owner or the annuitant. In either form of contract, Owner-Driven or Annuitant-Driven, changes to beneficiaries (primary or contingent) may always be made. A key to death benefit payouts is to know on whose life the enhanced benefits are actually based. The owner or the annuitant can trigger enhancement of death benefits.

- Owner-Driven contract, death benefits are based on the death of the owner.
- Annuity-Driven contract, death benefits are based upon the death of the annuitant.
  - On the owner’s death, distributions will occur as “distributions of annuity assets.”
  - On the death of the annuitant the distributions will come out in the form of “death benefits” (enhanced or not).

The different handling can bring about adverse income tax, gift tax, and premature distribution penalties to various named parties to the annuity contract.

C. Rights and Obligations of the Insurance Company

Qualified and nonqualified annuity contracts allow the contract holder to defer taxes on earnings credited under the contract. Qualified annuities (e.g., annuity contracts purchased through a 401(k) or 403(b) pension plan or an individual retirement account) also allow the deferral of income taxes on principal invested in the annuity. IRS guidelines must be followed to determine the tax status (qualified or nonqualified) of an annuity. Since annuities are insurance products, they are also subject to regulation under the California Insurance Code. The Insurance Code places additional responsibilities on insurers offering qualified or nonqualified annuities to California seniors. With regard to the rights and obligations of insurers, a ‘senior citizen’ is defined as an individual who has reached the age of 60 at the time of an annuity contract purchase.

1. Rights and Obligations of Insurer

For both Qualified and Non-Qualified policies, obligations that fall on the insurer issuing life or annuity policies issued to a senior citizen are as follows;

1.) **Return Policy-** For all policies issued after July 1, 2004, the insurer must notify the purchaser of the return policy. Seniors are allowed a 30-day free look. Text of the return policy can be found in Section IX G of this text. For individual policies, all premiums and fees must be returned within 30 days. The written notice must be displayed in a prominent manner on the policy’s cover page or jacket or on a sticker affixed to the cover page or jacket.

2.) **Refunds and Cancellations-** For annuity contracts and variable annuity contracts which the owner has not directed that the premium be invested in mutual funds underlying the contract during the cancellation period, return of the policy during the cancellation period shall have the effect of voiding the policy from the beginning, and the parties shall be in the same position as if no policy had been issued. All premiums paid and any policy fee paid for the policy are to be refunded by the insurer to the owner within 30 days from the date that the insurer is notified that the owner has canceled the policy. In the case of a variable annuity for which the owner has directed that the premium be invested in the mutual funds underlying the contract during the 30-day cancellation period, cancellation shall entitle the owner to a refund of the account value.

3.) **Non-Guaranteed Values-** The insurer must cause to be displayed on the face of any policy illustrations a notice regarding nonguaranteed values and identify those values as being such. The 'Illustration Only' notice can be found in Section IX B 2. Preprinted policy illustrations must contain this notice in 12-point bold print with at least one-half inch space on all four sides, printed on the illustration form itself or on an attached cover sheet, or in the form of a contrasting color sticker placed on the front of the illustration. All preprinted illustrations containing nonguaranteed values shall show the columns of guaranteed values in bold print. All other columns used in the illustration shall be in standard print. "Values" as used here includes cash value, surrender value, and death benefit.

4.) **Annual Statement-** When an insurer provides an annual statement, the duty arises to supply current accumulation and cash surrender values. Whenever an insurer provides an annual statement to a senior citizen policyowner of an individual life insurance policy or an individual annuity contract issued after January 1, 1995, the duty arises for the insurer to also provide the current accumulation value and the current cash surrender value of the contract.

5.) **Surrender Charge-** Prominently disclose the existence of any surrender charge. The statement regarding surrender charge must make known the applicable surrender charge period and penalties associated with contract surrender. A detailed discussion of the surrender charge can be found in Section V A 4.

6.) **Replacement Policy-** Follow (and make certain agents follow) guidelines regarding replacement policy as found in the California Insurance Code. If a replacement policy is involved, the replacing insurer shall provide in the policy or a written notice that the applicant has a 30-day right to the refund of premiums. In the case of variable annuity contracts, return of the contract during the cancellation period entitles the owner to a refund of account value and any policy fee paid.

(Sections 10127.10,10127.11, 10127.12, 10127.13 and 10509.6 of the CIC)

2. Rights and Obligations of Insurer, Qualified

For qualified policies, obligations that fall on the insurer issuing life or annuity policies issued to a senior citizen are as in the previous section. Additionally, the qualified annuity contract must contain a non-transferability clause. The reason is if a loan is received under an annuity contract, the amount received is treated as an amount not received as an annuity and included in current income. This is true whether the amount is received directly under the contract from the insurer or indirectly from another source. Any assignment or pledge of an annuity contract used to obtain a loan from a third party is considered to be an amount not received as an annuity. If a person borrows money from his or her retirement plan, the loan must be treated as a nonperiodic distribution from the plan unless it qualifies for the purchase of a new home exception explained in Section VII D. Qualified annuity contracts must include non-transferability language because a loan will be treated as a distribution.

3. Insurance Rating Services

Rating services appraise companies based on information provided to them by the insurers. The rating services are A. M. Best, Standard & Poor's and Weiss. Here is a brief explanation of their rating scales, as taken from their websites;

A.M. Best Co.- The ratings are divided into two broad categories- Secure and Vulnerable. Secure rated companies have experienced a significantly lower failure frequency than Vulnerable rated companies. The company has a rating scale for both secure and vulnerable companies.

Moody's- Financial strength ratings are opinions about the ability of insurers to pay obligations. Moody's looks at quantitative and qualitative factors. Ratings focus on identifying risks, reflecting expected loss and default risk of investment. The ratings qualify companies that are safe to those thought to be in a weak position.

Standard & Poor's- This company issues an insurance claims-paying ability rating. The rating is an opinion of an operating insurance company's financial capacity to meet the obligations of its insurance policies in accordance with their terms. Claims-paying ability ratings do not refer to an insurer's ability to meet nonpolicy obligations (i.e., debt contracts). Ratings of debt issued by insurance companies, or to debt issues that are fully or partially supported by insurance policies, is a separate process. Claims-paying ability ratings are divided into two broad classifications; "Secure" rated companies possess financial capacity to meet policyholder obligations which is viewed, on balance, as sound. "Vulnerable" ratings are used to indicate insurers whose financial capacity to meet policyholder obligations is viewed as vulnerable to adverse economic and underwriting conditions.

Weiss Rating- The Weiss Rating Company will provide those interested with a report concerning investment and safety ratings for any particular company. There is a cost for the service. The website is located at www.weissratings.com.

4. Advertising Responsibilities

When an insurance company advertises, it is making the product known to the public at large. Advertising must be presented in an honest and ethical manner. Regulation applies to advertising directed to Californians age 65 or over. In this case "advertising" refers to any materials (business cards, stationary, envelopes, etc.) designed to encourage the purchase of a policy. Here is a list of things insurers must not do, as well as a list of things that are required of insurance ads.

Advertising Prohibitions-

- The advertising cannot use misleading words, symbols or devices that imply a non-existent affiliation to other groups such as: state or federal government, political subdivisions of the government, charitable or eleemosynary institutions, or senior citizen groups.
- Advertising cannot imply that the reader may lose a right, privilege or benefit under federal, state or local law if he or she does not respond to the ad.
- Ads shall not use any name, nickname or *nom de guerre* that might detract someone else from understanding the agent's true purpose- seller of insurance products.
- Ads must not solicit groups or classes of people with fictitious or implied reduced

‘group’ rates

- Insurers and agents are prohibited from soliciting any particular class of individuals by stating or implying the occupation or status of the members of this particular class entitles them to reduced rates on a group or other basis when the policy is being sold on an individual basis.
- Advertising may not use the name of a state or political subdivision of a state in a policy name or description.
- An address cannot be used that would mislead a reader as to the insurers’ identity, location, or license status.

Advertising Requirements-

- Advertising designed to produce leads, based on a response from a potential insured, must make known that an agent may contact the applicant if that is the case.
- Agents who make contact through such advertising leads are required to disclose this fact to the potential insured upon initial contact.
- Ads used by an insurance sales force must have the written approval of the insurer before being used.
- Any event using terms such as “seminar,” “class,” “informational meeting,” or the like where insurance products will be sold must add the phrase “and insurance sales presentation” immediately following those terms in the same type size and font. (Section 787 of the CIC)

5. Policy Cancellation and Refunds

Insurance products sold to individuals 60 years of age or over in California shall provide an examination period of 30 days after receipt for the purpose of review of the contract. Return during this “free look” period voids the policy, with premiums fully refundable. If premiums or fees are not refunded in a timely manner (no later than 30 days) interest shall be due on the outstanding balance at the statutorily prescribed rate. Policies and certificates are to note this right of return on the cover page in at least 10-POINT UPPERCASE TYPE. (Section 786 of the CIC)

Section 10127.10 of the California Insurance Code goes on to say that any policy delivered after July 1, 2004 must have the cancellation/refund notice printed or attached to it. Delivering or mailing it to the insurer or agent from whom it was purchased can cancel the policy. The insured may return the policy by mail or otherwise during the 30 day period.

If a variable annuity has been purchased, the premium may be invested only in fixed-income or money market funds unless the investor specifically directs otherwise. Return of the policy within the 30 days shall have one of the following effects;

1.) If the owner has not directed the premiums be invested in mutual funds underlying the variable annuity contract the cancellation has the effect of voiding the policy from the beginning with all premiums and fees refunded by the insurer within 30 days of cancellation of the policy
2.) If the owner directed premiums be invested in the mutual funds, cancellation entitles the owner to a refund of the account values within 30 days of cancellation notification.

For all individual policies issued or delivered after January 1, 2004, or in effect after January 1, 2003, the notice found in Section IX G of this book must be provided.

If a replacement policy is involved, the replacing insurer shall provide in the policy or a written notice that the applicant has a 30 day right to the refund of premiums. In the case of variable annuity contracts, variable life insurance contracts, and modified guaranteed contracts, return of the contract during the cancellation period entitles the owner to a refund of account value and any policy fee paid. (Section 10509.6 of the CIC)

D. Rights and Options Available to Beneficiaries

1. Effects of SB 483 on Beneficiaries

There are possible effects on the rights of beneficiaries under the changes to the law brought about by Senate Bill 483. This bill was passed as a response to the Federal Deficit Reduction Act (DRA) of 2005. The DRA SB 483 contains numerous requirements related to annuities. Under this bill, the state is required as a result of providing Medi-Cal for home and facility care to an individual, to become a remainder beneficiary of annuities purchased by an individual or his or her spouse in which the individual or his or her spouse is an annuitant (a remainder beneficiary is the entity entitled to receive what remains of the principal after the death of the beneficiaries). There are exemptions from this requirement, such as if the individual or his or her spouse notifies California Department of Health Care Services (DHCS) in writing that he or she prohibits the state from acquiring a remainder interest in his or her annuity, in which case the purchase of the annuity is required to be treated as the transfer of an asset for less than fair market value that can result in an individual's ineligibility for Medi-Cal. Under this bill, when the state becomes aware of an annuity in which it has acquired a remainder interest, it must notify the issuer of the annuity of the state's acquisition of its remainder beneficiary interest. Annuity issuers are required, after being notified by DHCS, to immediately inform DHCS of the amount of income and principal being withdrawn from the annuity as of the date of the individual's disclosure of the annuity, and to notify DHCS if there is any change in either the amount of income or principal being withdrawn from that annuity or the named beneficiaries of the annuity. The state is prohibited from becoming a remainder beneficiary of an annuity that is any of the following: a) Purchased by a community spouse with resources of the community spouse during the continuous period in which the individual is receiving Medi-Cal home and facility care and after the month in which the individual is determined eligible for these benefits; b) Contained in a retirement plan qualified under specified provisions of federal law established by an employer or an individual, including, but not limited to, an Individual Retirement Annuity or Account (IRA), Roth IRA, or Keogh fund; or, c) An annuity that is all of the following: i) The annuity is irrevocable and nonassignable; ii) The annuity is actuarially sound; and, iii) The annuity provides for payments in equal amounts during the term of the annuity, with no deferral and no SB 483 Page 8 balloon payments made from the annuity. Individuals or the community spouse (or both) bear the burden of demonstrating that limit the state's right to become a remainder beneficiary, are met.

2. Settlement Options Available to Beneficiaries

Annuity structures should be as simple and clean as possible, which, in most cases, means avoiding joint owners and annuitants. In the case of spouses, naming anyone other than the surviving spouse as primary beneficiary should be avoided, or if done, a lot of caution should be used.

a. As a Surviving Spouse

The Spousal continuation Rule [IRC 72(s)] states that the deceased owner's surviving spouse can become the contract owner. The surviving spouse can then continue the contract throughout his or her lifetime and is not forced to take a distribution. However, not all insurance annuity contracts offer the spousal continuation provision. If anyone else is named as a primary beneficiary along with the spouse, the option of the surviving spouse becoming the contract owner is usually lost. In cases where a child and spouse are named as primary beneficiaries, some companies will allow spousal continuation but only on the spouse's remaining portion of the contract. The IRC states only that the beneficiary be a spouse; however, some contracts specify that the spousal election letter will only be sent out if the surviving spouse is the "sole" beneficiary, which is a narrower interpretation of IRC.

Under the tax code, the spouse as the beneficiary of an annuity contract may choose not to accept the death benefit and instead may choose to continue the annuity contract with the insurance company. The insurance company will change the owner from the deceased person's name to that of the surviving spouse. The surviving spouse now has the right as the owner to name a new beneficiary. This right exists whether the policy is a nonqualified annuity contract or a qualified annuity contract.

b. Entity Other Than Surviving Spouse

Problems can and do arise when multiple primary beneficiaries are named, or primary beneficiaries other than a spouse are named. Therefore, such structuring arrangements require great care and caution. If the death occurs prior to the time that annuitization payments have begun and an individual who is not a spouse is the beneficiary, the contract proceeds payable to that non-spouse beneficiary must either be distributed (1) within 5 years of the death of the annuitant/owner or (2) as an annuity based on the life expectancy of the beneficiary, as long as payments begin within one year of the date of the owner's death.

Trusts can be designated as beneficiaries or even as contingent beneficiaries of an annuity. First, there is no need to do this because annuities pass probate free, and second, trusts do not allow for any form of spousal continuation or lifetime annuitization because a trust is considered to be a "non-natural person." (For more information on this, see the Non-Natural Person Rule that applies to contributions into annuities after February 28, 1986). Third, trusts limit payout options to only the first two options listed above resulting in a 50% reduct6ion in payout flexibility. This impedes income tax efficiencies on lesser-taxed distributions, which otherwise could be stretched out. When making a trust the owner it is important to know whether the insurance company that's issuing the annuity views the trust as either a "natural" or "non-natural person" especially in revocable trusts (living trusts) where there are often spouses involved. If they view the owner/trust as a trust, they will not allow for spousal continuation; hence, another problem with making a trust the owner of an annuity. There is no look-through provision on non-qualified annuities (i.e. where the IRS will “look through” the grantor/trustee designation and recognize the spouse for spousal continuation rights). The “look-through provision” applies only to IRS-provided rationale for IRAs/qualified plans when a trust is the beneficiary. Those wishing to deploy this tool should proceed very carefully when using a trust as any part of an annuity structure. Advisors should require and obtain a written letter of instruction from the client’s attorney on exactly how they want the structuring set up under an annuity contract. Annuities are a sound investment for many, but as seen in the examples in this article, they must also be properly structured to achieve their fullest potential.

V How Fixed, Variable, and Index Annuity Contract Provisions Affect Consumers

A. Identifying and Discussing Contract Provisions

The provisions described here are all common but each one is not available in every contract. **Purchasers must read the contract!** The terms and conditions should be understood by the buyer before completion of the sale. The descriptions here are examples only. Features included in a contract will be defined in the contract. Thus the “owner,” “annuitant,” and “beneficiary” will all be spelled out in the contract definitions.

Contract loans- A loan provision may be included in an annuity contract. In general, this feature allows one to borrow up to a specified amount of the annuity’s accumulated value. Since it is a loan, interest will accumulate and it most likely will be to the owner’s advantage to repay it. Like the withdrawal privilege, a loan provision can give some liquid features to an annuity.

Return of principal guarantee - Surrender of the contract should be avoided whenever possible, but individual circumstances may leave a person with no other choice. If an annuity must be surrendered, this feature gives assurance that the company will pay no less than the total dollars that have been paid in premiums (minus any prior partial withdrawals). It applies even if the amount is greater than the cash surrender value defined by the contract.

Minimum Initial Premium- Each annuity contract will designate a minimum premium that the policyowner must pay to purchase an annuity. Normally these amounts are in the $5,000–$10,000 range for single-premium policies and $25–$50 per month for flexible-premium policies. Insurance companies may designate a different minimum amount, depending on the type of funds the client places inside the annuity. For example, a policy might show a minimum premium of $1,000 for a qualified single-premium annuity but still keep the nonqualified annuity minimum premium at $5,000. Lower premium amounts are common for qualified contracts so that the annuity can accept small annual IRA contributions.

Issue Age Each annuity contract will have a provision for the minimum and maximum age of the owner or the annuitant who can purchase the contract. Generally, the insurance company is more interested in the age of the annuitant for purposes of mortality. But the issue age of the owner is also important because of legal issues related to minors who purchase the contract. Normally, an insurance company does not want a minor to own one of its policies because of the minor's legal right, upon reaching the age of 18, to rescind a purchase made while he or she was a minor. Usually, annuity contracts allow annuitants between the ages of 18 and 85. Some companies may stop issuing annuities at age 70 or 75; other companies will issue annuities up to age 90. In addition, the insurance company may limit the issue age based on the type of funds in the annuity. Qualified annuity contracts typically carry a maximum issue age of 70, while nonqualified annuities will be issued to age 85 or 90. The reason for the qualified funds' limitation is based on the minimum distribution requirements for qualified annuity contracts. The tax code stipulates that qualified plans distribute a certain percentage of the account after the owner reaches age 70 1/2.

Options Involving the Spouse- The spouse as the beneficiary of an annuity contract may choose not to accept the death benefit and instead may choose to continue the annuity contract with the insurance company. The insurance company will change the owner from the deceased person's name to that of the spouse.

Settlement Options- Deferred annuity contracts also include provisions for taking the money out of the contract at some future contract-owner-determined date- called annuitization- or at some other agreed-upon date. These optional modes of settlement may be taking a lump-sum withdrawal, leaving the proceeds in the contract at interest, choosing fixed-period or fixed-amount payments, or selecting the various life contingent or joint-life-contingent options. Little attention is given to these contractual provisions in periods of high interest rates. As interest rates fall and longevity has increased, the guaranteed lifetime annuitization factors and interest rate guarantees of 3% have real value in comparison to the guarantees in new annuity contracts. The minimum payout rates for settlement options are listed in the annuity policy. In a normal economy, these rates are much lower than what the annuity company can afford to pay. Therefore, it is important for the owner to look at the guaranteed settlement option rates in the policy and compare those rates to the current offerings from the insurance company to be sure to obtain the best rates available. Surrender of the contract should be avoided whenever possible, but circumstances may leave the policyholder with no choice. If someone must surrender his or her annuity, this feature gives assurance that the company will pay no less than the total dollars that have been paid in premiums — minus any prior partial withdrawals already taken. It applies even if the amount is greater than the cash surrender value defined by the contract.

Death Benefits- If the entire annuity value is not consumed during retirement, when the annuitant dies, the annuity will still be in force. Annuities contracts have provide for a beneficiary or some other party to legally receive the values at the annuitant's death. The death benefit can be classified in one of two ways depending on how the death benefit is payable in the policy: Policies are either annuitant driven or owner driven. These differences are discussed in Section IV A & B.

1. Issue Ages

The insurance contract has the basic elements of any other contract. Those elements are summarized (not in correct order) by the acronym COALL. It stands for Consideration, Offer, Acceptance, Legal capacity to contract, and Legality of subject matter. Notice should be given to the fact that <u>in writing</u> is not an element that must be present to have a valid contract. This is important where the concepts of waiver and estoppel are concerned, but beyond the text’s scope. Generally speaking, a person has the legal capacity to contract when he or she reaches the age of majority, 18 years. In common law, persons under 18 can contract, but the contract is voidable at his or her discretion.

At the upper-end of the age spectrum contracts allow annuitants up to age 85. Some companies may stop issuing annuities at age 70 or 75; other companies will issue annuities up to age 90. In addition, the insurance company may limit the issue age based on the type of funds in the annuity. Qualified annuity contracts typically carry a maximum issue age of 70, while nonqualified annuities will be issued to age 85 or 90. The reason for the qualified funds’ limitation is based on the minimum distribution requirements for qualified annuity contracts. The tax code stipulates that qualified plans distribute a certain percentage of the account after the owner reaches age 70 1/2.

With respect to insurance and annuity contracts, the common law provisions have been modified by statute. An insurance or annuity contract may be issued to or indicate the named insured as a person under the age of 18 for the benefit of the minor or for the benefit of the parents, spouse, child, or siblings of the minor. Likewise, a contract can be issued to a minor, subject to written consent of a parent or guardian, upon the life of any person in whom the minor has an insurable interest for the minor’s benefit or such minor's parents, spouse, or siblings. Subject to approval of a parent or guardian, a minor may give a valid discharge for any benefit accruing or for any money payable. Contractual matters involving minors under the age of 16, as determined by the nearest birthday (meaning 15½), need the written consent of a parent or guardian. These minimum age limitations are subject to the terms of the California Probate Code, which gives mechanisms for a guardian or conservator to act in *loco parentis,* in the place of the parents. That is, in the best interest of the ward or conservatee. (Section 10112 of the CIC)

2. Maximum Ages for Benefits to Begin

Non-Qualified Annuities- Annuities are based on life expectancy. Being non-qualified, the tax code specifies no maximum age limitation for contributions or withdrawals. It is at the issuer’s discretion as to age at which payments must begin. Once annuitization occurs, payments must be spread evenly over the life expectancy of the annuitant.

Qualified Plans- To make sure that most of the retirement benefits are paid to the plan participant during his or her lifetime, rather than to subsequent beneficiaries after an individual’s death, the payments that are received from qualified retirement plans must begin no later than the plan participant’s ***required beginning date*** (defined later). The payments each year cannot be less than the ***minimum required distribution***.

If the actual distributions to an individual in any year are less than the minimum required distribution for that year, he or she is subject to an additional tax. The tax equals 50% of the part of the required minimum distribution that was not distributed. A qualified retirement plan includes a qualified employee annuity plan and a tax-sheltered annuity plan (403(b) plan) (for benefits accruing after 1986).

Required beginning date. Unless the rule for 5% owners and IRAs applies, the plan participant must begin to receive distributions from the qualified retirement plan by April 1 of the year that follows the ***later*** of:

- The calendar year in which the subject individual reaches age 70½, or
- The calendar year in which the person retires.

***5% owners**.* If a person is a 5% owner of the employer maintaining the qualified retirement plan, the plan participant must begin to receive distributions from the plan by April 1 of the year that follows the calendar year in which he or she reaches age 70½. This rule does not apply if the retirement plan is a government or church plan.

A person is a 5% owner if, for the plan year ending in the calendar year in which he or she reaches age 70½, the person in question owns (or is considered to own under section 318 of the Internal Revenue Code) more than 5% of the outstanding stock (or more than 5% of the total voting power of all stock) of the employer, or more than 5% of the capital or profits interest in the employer.

***Age 70½** .* A person reaches age 70½ on the date that is 6 calendar months after the date of their 70th birthday. For example, if your 70th birthday was on June 30, 2018, you reached age 70½ on December 30, 2018. If your 70th birthday was on July 1, 2018, you reached age 70½ on January 1, 2019.

Required distributions. By the required beginning date, as explained above, the plan participant must either:

1) Receive his or her entire interest in the plan (for a tax-sheltered annuity, the entire benefit accruing after 1986), or
2) Begin receiving periodic distributions in annual amounts calculated to distribute the entire interest (for a tax-sheltered annuity, the individual's entire benefit accruing after 1986) over a person's life or life expectancy or over the joint lives or joint life expectancies of the plan participant and his or her designated beneficiary (or over a shorter period).

3. Premium Payments

Incorporated life insurers that issue policies on the reserve basis can collect premiums in advance. Insurers are limited by statute as to the amount of advance premium that can be collected. However, the Insurance Code does not limit the ability of insurers to accept payment under an agreement that provides for an accumulation of such funds for the purpose of purchasing annuities at future dates. (Section 10540 of the CIC)

4. Surrender Charges

Annuity contracts carry a surrender charge. A typical contract could have a surrender charge in effect over the first 10 years, but decreasing in amount each year. The contract will explain how the surrender charge applies. An annuity is a long-term investment. The surrender charge discourages the annuity owner from using the funds as a piggy bank. It also allows the insurer to cover the expense of selling and issuing the contract. The charge is usually a percentage of either the fund's accumulated value or the total premiums paid. Surrender charges are generally waived under certain circumstances, such as death or disability of the annuitant.

Annuity contracts for senior citizens that contain a surrender charge period need to disclose the surrender period and all associated penalties in 12-point bold print on the cover sheet of the policy or disclose the location of the surrender information in bold 12-point print on the cover page of the policy, or printed on a sticker that is affixed to the cover page or to the policy jacket. The notice required by this section may appear on a cover sheet that also contains the disclosure required by subdivision (d) of California Insurance Code Section 10127.10, which be found in the “Free Look Period,” of this book. (Section 10127.13 of the CIC)
The word “values” as used in other sections of this book includes surrender value. (Section 10127.11 of the CIC)

Whenever an insurer provides an annual statement to a senior citizen policyowner of an individual life insurance policy or an individual annuity contract issued after January 1, 1995, the insurer shall also provide the current accumulation value and the current cash surrender value. (Section 10127.12 of the CIC)

a. Market Value Adjustment

Market value adjustments are features added to some deferred annuities to discourage surrenders prior to their contractual maturity date. If, during the contract period and before the maturity date, money in excess of any free-corridor amount is withdrawn, it is subject to a market value adjustment. The market value adjustment is an increase or decrease in the annuity’s value, depending on the level of the general economy’s interest rates relative to the interest rates of the contract from which the withdrawal is taken. Annuities with market value adjustment features often offer a slightly higher interest rate than a comparable fixed annuity without such features. The market value adjustment works in the annuity contract in a manner similar to the way individual bond prices fluctuate. For example, if a contract owner has an annuity with a contractual interest rate of 8 percent with 5 years left prior to its maturity date, and similar contracts are being issued with 4 percent interest rates, the contract owner can expect some gain upon early surrender. This is because the surrender will relieve the insurance company from its 8 percent obligation in a market where interest rates have decreased to 4 percent. On the other hand, if the opposite occurred and the old contractual obligation was for 4 percent in a current interest rate market of 8 percent, the contract owner can expect a negative MVA and therefore will receive a smaller

b. Impact of Surrender Charges on Principal

Surrender charges are a reduction of principal. They do not reduce the interest earned portion of an annuity. Subsequent earnings will be reduced because of the reduction of principal. The idea is to make it less tempting for annuity owners to draw funds out of the contract and allow the insurer to recover costs associated with the contract. Surrender charges are commonly deducted from withdrawals. There may also be a limited free withdrawal privilege.

c. Surrender Charge Waivers- Triggering Events

With a waiver, access can be provided to an annuity before retirement. Some annuities contain a waiver that triggers payments not subject to the usual surrender fees.
Nursing Home- One insurer might require a 90-day nursing home confinement before

benefits are activated, while another might call for 60 days. With a nursing home waiver, surrender fees will not be charged and access is granted to some or the entire annuity if an individual is put in a nursing facility. A 90-day confinement period before benefits begin may be typical, longer periods could apply. A doctor will normally be asked to then submit an attending physician's statement, along with a completed claim form.
Terminal Illness- The same can hold true if a policyholder becomes terminally ill, thus allowing access to money when it may be needed most. The definition of terminally ill may vary from company to company; it's generally a condition that will result in death within six months to a year.
Unemployment- This is another condition for which a waiver of surrender charges could be added.
Disability- With this type of waiver, one company may consider an individual disabled if he or she is unable to work in any occupation, while another may require only that a person is unable to work in their current vocation The risk of disability is greater than the risk of death at all ages between 20 and 65. It is prudent to protect oneself financially if disability does occur, and that includes annuity considerations.
Charges and Fees- In most cases, there is no extra charge for such crisis waivers because they are built into the contract when purchased. Variable annuity contracts may offer crisis waivers for an additional expense. Certain tax consequences could apply to such withdrawals. The insurance professional should advise clients to check with a tax advisor before withdrawing funds from an annuity.
Death- Informal internet survey shows an almost universal surrender charge waiver for this event.

d. Required Notice and Printing Requirements

When penalties are associated with surrender of the contract the notification requirement can be met through a notice in 12-point bold print on the cover page making the mandated disclosures or by indicating the location of this information in the policy. Notice information can be found in Section IX G, ‘Policy Cancellations and Refunds.’

5. Policy Administration Charges and Fees

Every insurer that sells annuities charges fees which are connected to the contract. These fees cover the company’s costs of administering the annuity. Annuities may charge a nominal annual contract maintenance fee such as one percent of the cash value not to exceed $20–$50. These fees are usually deducted from the annuity cash values, and they will often expire when the contract accrues a certain amount of cash value such as $5,000 or $10,000. This contract provision less has become less common in newly issued annuity contracts.

6. Withdrawal Privilege Options

In the event the policyowner needs to access funds prior to maturity, the owner has the option of requesting a withdrawal, also called a partial surrender. Withdrawal provisions in deferred annuity contracts allow the policyowner limited withdrawal of funds prior to maturity of the contract. The surrender or withdrawal, if made during the surrender charge period, is normally subject to a surrender charge. If the withdrawal is requested after the policy is beyond its surrender charge period, the policyowner should be able to access the withdrawal without any charges imposed by the insurance company.

Withdrawals are not expected to be repaid to the annuity contract. With flexible-premium policies, the withdrawal can later be paid into the annuity policy as new premiums. Annuity policies do not generally have loan provisions available to the policyowner due to tax consequences.

Free-Corridor Amount- To accommodate a contract owner's unforeseen need for money, practically all companies provide a free withdrawal corridor. A free corridor is some maximum amount of money that a contract owner can withdraw from the contract each year without incurring a surrender charge. If a contract owner elects to make an early withdrawal of just part of the funds in an annuity contract before the end of the surrender charge period, there is likely to be a free-corridor amount that he or she can withdraw without any charge. Normally, this amount is about 10 percent of the last year's accumulation value or 10 percent of the initial premium paid. However, some contracts do not allow any withdrawals without charge; the most generous allow withdrawals of up to 15 percent per contract year without charge. Amounts in excess of the free corridor amount are subject to proportional surrender charges. A prospective purchaser should carefully examine surrender charges and free-corridor provisions.

B. Identify and Discuss Income Distributions

How income distributions are taxed depends on whether they are *periodic payments* (amounts received as an annuity) that are paid at regular intervals over several years or *nonperiodic payments* (amounts not received as an annuity). This material is presented as introductory material only. Tax statutes can change every year. **IRS publications or a tax professional should be consulted before completing tax returns**

1. Introduction to Application of a Split Annuity

A split annuity involves simultaneously purchasing at least two annuities with a single premium payment. The term "split annuity" involves the splitting of a lump sum of money between two or more annuities. A split annuity is a retirement planning approach aimed at providing current income, preserving principal value or capital. An individual simultaneously buys an immediate annuity for a term certain and a deferred annuity for a single premium. The premium is divided between the immediate and deferred annuities so that, at current interest rates, the deferred annuity's accumulation value at the end of the immediate annuity's term certain will approximately equal the total original premium.

For retirement planning purposes, the split annuity can provide a larger monthly income than a CD, and if properly structured eliminates investment risk. The split annuity combines two types of annuities, an immediate and deferred annuity. The immediate annuity will pay a guaranteed monthly income while the deferred annuity allows the money to be left to grow without being inhibited by income taxes. The money that is growing inside the deferred annuity replaces the money that is being paid to the annuitant from the immediate annuity. This enables the retiree to maintain a level investment account, similar to a CD or an investment in a bond.

2. Introduction to Various Settlement Options

Settlement options are the various methods by which an annuity can be liquidated. It is the payment option. Generally, the annuity owner makes the settlement option selection. It can be made when the contract is purchased or delayed until the time benefit payments begin.

a. Life Annuity

The life annuity is a general payout category in which the payout is guaranteed for life. Sometimes known as a straight life annuity, the life annuity pays a benefit for as long as the annuitant lives, and then it ends. Whether the annuitant lives past 100 years of age or dies one month after the annuity period starts, the annuity payments will continue only until he or she dies. In other words, there is no guarantee as to the minimum amount of benefits under a life annuity.

There is a risk to the annuitant that he or she might not live long enough once the annuity period begins to collect the full value of the annuity. If an annuitant dies shortly after benefits begin, the insurer keeps the balance of the unpaid benefits. This settlement option will pay the highest amount of monthly income to the annuitant because it's based only on life expectancy with no further payments after the death of the annuitant.

b. Joint Survivor

Joint life annuities protect the annuitant and a coannuitant (such as a spouse) against outliving their resources. With a joint life and survivorship (or last survivor) annuity, there are more than one (usually two) annuitants, and both receive payments until one of them dies. A stated monthly amount is paid to the annuitant and upon the annuitant's death, the same or a lesser amount is paid for the lifetime of the survivor. The joint-survivor option is usually chosen as one of three alternatives: joint and 100% survivor, joint and two-thirds survivor, or joint and 50% survivor. The reasoning is that the survivor of the two annuitants may see a reduction in living expenses and not need as much income to live as before the first annuitant’s death. To counter that reasoning, depending upon the remaining annuitant’s other income, remaining lifespan, and inflation rate, the remaining annuitant may not see a reduction in expenses at all.

c. Period Certain

The easiest settlement concept is the fixed period annuity. The fixed period settlement option allows the annuitant to receive the accumulated value in the annuity over a set number of years. So, the annuitant could elect to receive the accumulated value over a five or ten year period. The formula to use to determine the periodic value of the payments is the same as the loan payment formula;

Calculating the Payment Amount per Period

The formula for calculating the payment amount is shown below.

$$A = P\,\frac{r(1+r)^n}{(1+r)^n - 1}$$

where

A = payment Amount per period
P = initial Principal (loan amount)
r = interest rate per period
n = total number of payments or periods

If they have not already done so, the insurance professional should become familiar with present/future value concepts. The present value concept and time value of money calculations can be practiced on the Internet or on a reasonably-priced hand-held business function calculator.

d. Cash Refunds

A cash refund annuity refunds the unpaid nominal amount of the premium in the event that the annuitant dies before the full amount of the initial premium has been distributed. The differences in purchase rates are a function of time and interest rates. If the annuitant dies before receiving total income at least equal to the premiums paid, the beneficiary receives the difference in a lump sum.

3. Advantages and Disadvantages of Annuitization Options

Many variables are involved in determining the proper annuitization option for individual purchasers of annuity products, including their Social Security income, other annuity income sources, out-of-plan retirement savings, other assets (real estate, etc.) and participants' overall health. The complexities involved in evaluating each individual's situation mean that any default requirement would need to be considered carefully. Two things are certain; the individual will have to decide a future course of action based on today's knowledge, and hindsight will always be 20-20. In any situation where annuitization is by choice (as opposed to being the only option for all, as in many defined benefit plans), adverse selection will increase costs as the healthier people select annuities at a higher rate. That is, those who think they will live longer will opt for straight annuitization. That cost will be subsidized by those who believe they will not survive as long; putting a premium on survivor-oriented options.

C. Identify and Discuss Fixed Annuities

Insurance companies develop and sell annuity contracts. The contract between the insurer and the client describes what happens during the accumulation and distribution phases of the contract. It sets forth the rights and obligations of the contracting parties. Generally speaking, the client agrees to be a purchaser and to place money into an annuity contract in order to have the rights offered under the contract. The insurance company agrees to the obligations because it has the capacity to meet those obligations and is in the business of doing so as a for-profit enterprise. Although insurance companies are regulated by the individual states and contract forms have to be acceptable to each state, in the interest of efficiency, there is a great deal of standardization in all annuity contracts.

1. Death Benefits

All deferred annuity contracts provide for a death benefit prior to the annuity starting date. Death payments after the annuity starting date would be a form of settlement option. Tax code changes in 1985 provide that a death benefit is payable if any owner of the annuity dies before the maturity date. See Section IV A & B for further discussion. Some annuities provide that a death benefit is payable only if the owner dies, so long as the contract provides for a new annuitant to take the place of the deceased annuitant.

a. Lump Sum vs. Annuitization

The amount of the death benefit payable under a deferred fixed annuity will normally be the accumulated value of the contract, possibly reduced by any applicable surrender charge. Variable annuities also provide a death benefit, based on total premiums paid or the annuity's account value. Federal tax law calls for the distribution within five years of a contract's entire cash value if the 'holder' (owner) dies before the maturity date. The entire death benefit must be distributed within five years of the date of the owner's death. Any portion of the participant's interest that is payable to a beneficiary designated by the participant must be distributed either under the five-year rule or under the following exception to the five-year rule (the life expectancy rule)

b. Provisions

There is an exception to the five-year rule, if the death benefit is paid as an annuity over the life, or a period not longer than the life expectancy, of the beneficiary and the payments start within one year of the owner's date of death. If an annuity contract has joint owners, the distributions at death rules are applied upon the first death. Under a special exception to the distribution at death rules, if the beneficiary is the surviving spouse of the owner, the annuity contract may be continued with the surviving spouse as the owner. If the owner of the annuity is a non-natural owner, then the annuitant's death triggers the distribution at death rules. In addition, the distribution at death rules is also triggered by a change in the annuitant on an annuity contract owned by a non-natural person.

2. Charges and Fees

Annuity contracts will designate a minimum premium that the policyowner must pay to purchase an annuity. Normally these amounts are in the $5,000–$10,000 range for single-premium policies and $25–$50 per month for flexible-premium policies. Insurance companies may designate a different minimum amount, depending on the type of funds the client places in the annuity. For example, a policy might show a minimum premium of $1,000 for a qualified single-premium annuity but still keep the nonqualified annuity minimum premium at $5,000. Lower premium amounts are common for qualified contracts so that the annuity can accept small annual IRA contributions. Deferred annuities may charge a nominal annual contract maintenance fee such as one percent of the cash value not to exceed $20–$50. These fees are usually deducted from the annuity cash values, and they will often expire when the contract accrues a certain amount of cash value such as $5,000 or $10,000. Recent competition among annuity products, however, has made this contract provision less common in newly issued annuity contracts.

3. Interest Rates Strategies

The amount of interest the annuity product earns is of primary importance to the owner of the policy. In addition, because the initial interest rate is guaranteed for some period of time in the terms of the contract, the length of the guarantee period is critical. A potential annuity purchaser needs to know how the insurance carrier has typically treated its policyholders in terms of renewal interest rates. These are the interest rates

declared once the initial guaranteed interest rate period has expired.
Two questions a person should ask when considering the purchase of an annuity are;

- What is the current interest rate being paid?
- For what length of time is that interest rate guaranteed? Will it be one year, two years, five years, or longer?

a. Annual

Annual interest rates are the interest rates guaranteed for one year. The length of time the annuity will pay the initial interest rate is important. Purchasers need to know how long they can count on the insurance company paying the higher initial interest rate. Often, the interest rate guarantee period is tied to the length of the annuity's surrender charge period. Fixed-interest deferred annuity contracts will also provide a minimum interest rate, and the insurance company guarantees that it will never credit an interest rate less than this percentage to the annuity. This rate has typically been 3 %. Interest rates in the economy fell towards 1% in the first half-decade of the 21st Century. Although a boon for contract holders, the 3% guaranteed rates caused insurers to see more money go out the window than was coming in the front door. The result has been a movement to tie minimum interest rates to economy-wide rates, not set them in stone.
Bonus Interest Rates- These are extra amounts of interest granted to new purchasers that are paid in addition to the normal stated current interest rate. Based on the total dollars contained in the contract during its first year, these rates are designed to attract money from existing annuity contracts. The agent and the potential purchaser should be well informed regarding any bonus interest rates. Bonus rates are enticements. Bigger enticements usually mean bigger constraints down the road when that bonus will be applied or earned. Forfeiture or withdrawal prior to the end of the surrender charge period could void the bonus

b. Multi-year

Multi-year guarantee annuities do not provide the liquidity of annual guarantee annuities and surrender charges are usually imposed if the annuity is surrendered prior to the end of the present guarantee period. Most annuities allow that for a specified period of time, usually 30 days, the multi-year guarantee contract can be surrendered without being penalized by surrender charges. If the annuity owner has not surrendered the annuity, it is then renewed for a multi-year period which is the same as the original period, although the annuity owner may select a different renewal period. Surrender charges for a multi-year guarantee annuity usually do not apply if withdrawals are of an amount that is less than the credited interest or if the annuity owner elects to receive periodic income payments (annuitizes). Of course, if the death of the owner of the annuity occurs then death benefits are paid with no surrender charge.

4. Crediting Methods

Companies use several methods to establish the current interest rate to be credited to their accumulation accounts.

a. Portfolio Rates

The portfolio average method credits all policyholders with a composite rate of interest that reflects the company's earnings on its entire portfolio of investments during the year in question. During periods of rising interest rates, the interest credited to the "new" contributions received during the year will be heavily influenced by the interest earned on investments attributable to "old" contributions; those received and invested 5, 10, 15 or more years earlier. The interest credited will therefore be stabilized. Thus, when interest rates are rising, contributions made in the year 199X earn 4%, funds placed in the accounts (old or new) in year 199Y earn 4.5%, and all funds in year 199Z earn 5%. When interest rates are falling, contributions made in the year 200X earn 4%, funds placed in the accounts (old or new) in year 200Y earn 3.5%, and all funds in year 200Z earn 3%.

b. New Money Rates

With new money rates (sometimes referred to as the ‘banding’), the contributions made by all policyholders in any given period are banded together and credited with a rate of interest consistent with the actual yield that such funds obtained during that period. If a company's average return on all money is 4% in a given period, the contributions made by all participants during the current period may be credited with 5% if the company was able to make new investments that, on average, returned in excess of 5% interest. Additionally, the interest rate credited on those contributions should continue to earn 5% until the monies are reinvested. After reinvestment, the interest on these contributions will change and the rate credited to contributions banded in the following period could be higher or lower.

With increasing interest rates and reinvestment of assets every year, an investment in year 199x might earns 5% (the new money rate for that year) and then earn 5.25% in the second year and 5.5% in the third year. An investment in year 2 earns 10% (the new money rate for that year) and then earns 10.25% in the second year and 10.5% in the third year. Finally, an investment in year 3 earns 11%.

c. First Year Bonus ‘Teaser’ Rates

This is additional interest granted to new purchasers of annuities that is paid on top of the normal stated current interest rate. These amounts are usually based on the total dollars contained in the contract during its first year. These annuities are often used to attract money from existing annuity contracts, which still may be subject to a surrender charge, by paying extra interest in the first year. This extra interest (the bonus) is designed to offset some of the loss caused by the termination of the old policy. A Bonus rates is an incentive to get people to purchase an annuity. Big bonus incentives mean bigger constraints on when that bonus will be applied or earned. Any forfeiture and possibly even a withdrawal prior to the end of the surrender charge period could void the bonus. Interest rate bonuses often encourage replacement of annuities. The policyowner is lured by the high interest rate and a bonus above the normal current interest rate; the annuity owner may feel that the bonus will help to offset any surrender penalties. Bonus annuities can bear much higher surrender charges than those annuities found without the feature.

d. Annualized Interest Rate Calculations on Bonuses – Fixed Accounts

Bonus interest rates are extra amounts of interest granted to new purchasers of fixed-interest deferred annuities that are paid in addition to the normal stated current interest rate. These amounts are usually based on the total dollars contained in the contract during its first year. Bonus plan annuities are designed to attract money from existing annuity contracts, which still may be subject to a surrender charge, by paying extra interest in the first year. This extra interest (the bonus) is designed to offset some of the loss caused by the termination of the old policy. Potential purchasers must understand that these bonuses have an indirect cost behind them. Thus, the agent must be sure to tell prospects of any circumstance in which the bonus will not be paid, such as early termination or surrender. Interest rate bonuses often encourage replacement of annuities. The policyowner is lured by the high interest rate and a bonus above the normal current interest rate; the annuity owner may feel that the bonus will help to offset any surrender penalties he or she may incur. Bonus annuities will bear much higher surrender charges than a nonbonus product, putting the policyowner at a still greater disadvantage.

5. Minimum guaranteed Interest Rates

The Standard Nonforfeiture Law (SNFL) for annuities was developed by the NAIC in the late 1970's. The model law mandates a 3% minimum guaranteed interest rate for fixed annuities. This minimum caused solvency concerns to emerge among insurers offering annuity products as interest rates drifted lower through the first half-decade of the beginning of the 21st Century. Many of the investments of life insurers do not provide yields sufficient to support a 3% guaranteed yield. California AB 284 (2003) is legislation that addresses the issue. The bill provides a uniform method of calculating minimum nonforfeiture amounts. It modifies the interest rate applicable to accumulations under annuity contracts, the amounts by which those accumulations may be decreased, and the minimum amount of considerations used to determine the minimum nonforfeiture amount. The new provisions apply to contracts issued on and after January 1, 2006, but insurers apply them, on a contract-form-by-contract-form basis, to any contract issued on or after January 1, 2004. The bill also allows the Insurance Commissioner to adopt regulations to implement the provisions.

The mechanics of rate determination can be outlined as follows:
The minimum nonforfeiture amount at any time at or prior to the commencement of any annuity payments shall be equal to an accumulation up to that time, at the **rates of interest indicated below**, of the net considerations paid prior to that time, decreased by any prior withdrawals or partial surrenders, an annual contract charge (currently $50), and state premium tax paid by the company for the contract, and any loans or indebtedness outstanding. The net considerations for a given contract year used to define the minimum nonforfeiture amount is 87.5 percent of premium during that contract year.
Interest rates- The interest rate used in determining minimum nonforfeiture amounts is the lesser of 3% or the following:

- The five-year Constant Maturity Treasury Rate reported by the Federal Reserve as of a date, or averaged over a period, rounded to the nearest one-twentieth of 1 percent, no longer than 15 months prior to the contract issue date or redetermination date, reduced by 125 basis points, where the resulting rate is not less than 1 percent.
- The interest rate applies for an initial period and may be redetermined for additional periods. The redetermination date, basis, and period are to be stated in the contract.

If a contract provides substantive participation in an equity-indexed benefit, it may increase the reduction described above by up to an additional 100 basis points to reflect the value of the equity index benefit. The present value at the contract issue date and at each redetermination date thereafter, of the additional reduction may not exceed the market value of the benefit. (Section 10168.25 of the CIC)

a. Low Interest Rate Environment Impact

The end of the first decade of the 21st Century was a period of low interest rates. If an annuity is purchased in such a time, the currently low-interest-rate environment will depress the payout received. When market interest rates are low, insurers (like everyone else) can only pay the prevailing low rate to ‘rent’ an annuity contract owner’s capital. In the future interest rates may rise. Personal circumstances often require potential annuity purchasers to decide now (whenever that ‘now’ may be) about how to use retirement funds.

D. Identify and Discuss Variable Annuities

As the name implies, with a variable annuity the annuity holder receives varying rates of return on the funds placed in the annuity. The return is dependent on the risk taken by the annuity holder and the economic performance of the various components of the annuity portfolio.

1. License Requirements

Variable annuities are structured to have both an investment component and an insurance element. During the accumulation phase, premium payments are used to purchase “investment units,” the price depending on the value of the variable annuity’s underlying asset portfolio.

a. Prospectus

Buyers of this product must be provided with a prospectus, a detailed document which provides information on the variable annuity and the investment options available. By investing in a product whose market value can fluctuate, the assumption of risk by the holder of the annuity is a key element of the variable annuity. A variable annuity contract or variable life insurance policy is subject to the prospectus delivery requirements of the Securities Act of 1933 (15 U.S.C. Section 77a et seq.). The SEC has opined that online securities offerings are governed by the same rules as traditional offerings and that anything that has traditionally been accomplished using paper media should also be possible using electronic media. For example, when an issuer or underwriter uses the Internet to deliver a prospectus, it must

- Provide **timely and adequate notice** of the delivery of information,
- Ensure that the online communication system is **easily accessible** to potential subscribers, and
- Create some **evidence of delivery** of the prospectus.

b. Financial Industry Regulatory Authority (FINRA)

A variable annuity is considered to be a security under federal law and is subject to regulation by the Department of Insurance and the Securities and Exchange Commission. Anyone selling a variable annuity must have the required securities licenses. The sale of variable annuities is overseen by the Financial Industry Regulatory Authority (FINRA) (the largest non-governmental regulator for all securities firms doing business in the United States). FINRA is a private corporation that acts as a self-regulatory organization (SRO). FINRA is the successor to the National Association of Securities Dealers (NASD). In July 2007, the SEC approved the formation of a new SRO to be a successor to NASD.

2. Typically Common Contract Provisions

The written contract forms the backbone of the insurance transaction. When reviewing a contract, certain language or clauses may seem abstruse to both agent and layperson. The purpose of this section is to help explain the purpose and effect of some of the terms found in contracts.

a. General vs. Separate Accounts

Variable annuities allow money to be invested in insurance company "separate accounts" (which are sometimes referred to as "subaccounts" and in any case are functionally similar to mutual funds) in a tax-deferred manner. In addition, many variable annuity contracts offer a guaranteed minimum rate of return (either for a future withdrawal and/or in the case of the owner's death), even if the underlying separate account investments perform poorly. The separate account provides the variable investment options and along with the general account provides the foundation of a variable annuity. The investment fund options (often dozens of mutual funds) are referred to as subaccounts. In contrast to the general account, the separate account is not guaranteed by the insurance company. The returns of the subaccounts are variable rather than fixed, so the contract holder rather than the insurance company assumes market risk. The separate account is “separate” from the general assets of the insurance company, so there is no credit risk in the event that the insurer becomes insolvent.

b. Variable Options

There are several contract provisions common to variable annuities. Not all annuities will contain all provisions. It is important that the purchaser understands the several options available and makes an informed decision about which features he or she wants. Variable annuities feature a wide range of investment options during the accumulation phase. Like mutual funds, there are aggressive, bond, large cap, small cap, technology- the list goes on. The investor will be able to find something that works for their particular risk appetite and portfolio. Variable annuity contract holder settlement options are much like those offered under other annuity contracts. Settlement options are the methods by which the annuity owner can select to receive payments of benefits under the annuity contract.

c. Financial Industry Regulatory Authority

The Securities and Exchange Commission (SEC) has approved the Financial Industry Regulatory Authority’s (FINRA) new rules relating to variable annuity suitability and the supervision of variable annuity sales. FINRA includes the organization formerly known as the National Association of Securities Dealers (NASD). In July 2007, the SEC approved the formation of a new Self-Regulatory Organization (SRO) to be a successor to NASD. The NASD and the member regulation, enforcement and arbitration functions of the New York Stock Exchange were then consolidated into the Financial Industry Regulatory Authority (FINRA).

d. Equity-Based

Equity-based guarantees refer to applying equity indexes as an option in the valuation of the accounts. Some form of guarantee as to the minimum value is made by the insurer regarding the value of the portfolio held by the annuitant in the variable accounts. Such products are relatively new. The insurance industry has had limited experience in setting and implementing reserves for products containing equity-based guarantees. Furthermore, limited data on policyholder behavior makes it difficult for actuaries to develop methodologies for price and evaluate these products."

e. Risk-Based

This feature refers to interest rate risk. An interest rate guarantee based on bond or interest rate indexing is designed to guarantee the minimum value of the variable accounts in the variable annuity. Inflation, which is uncertain when the annuity is purchased, can reduce the real value of the annuity payout. The absence of markets for purchasing power-adjusted annuities has been pointed out as one of the important rationales for government-provided retirement income programs[8]. The introduction of Treasury securities which guarantee returns after inflation may lead to changes in this situation, and in particular, may facilitate the introduction of purchasing-power-adjusted annuities by some insurance companies.

3. Charges and Fees

The charges and fees under a variable annuity are different from those found in fixed annuities. This comes from the fact that variable annuities are subject to a greater degree of regulation because variable annuities are considered to be securities. The prospective purchaser of a variable annuity must be given a prospectus. Also, agents who sell these products must maintain a Securities and Exchange Commission license to sell securities, in addition to the state-issued license. Fees commonly charged to holders of variable annuities include;

Companies can charge a fee for each variable investment account to cover the extra management expenses associated with the particular account.

A mortality expense, generally 1%, is deducted proportionately from each of the variable accounts as well.

There can be a fee for switching between accounts or funds offered by the variable annuity. Annuity holders can transfer funds from the guaranteed account to (or between) variable accounts. A certain minimum number of such transfers might be gratis, after which fees apply. The issuer can also regulate timing or frequency of jumps between accounts.

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[8] “A Framework for Social Security Analysis,” Peter Diamond *Journal of Public Economics*, vol. 8, no. 3 (1977), pp. 275-298.

4. Dollar Cost Averaging

This is a system of buying securities on a regular basis with a fixed dollar amount at regular intervals. Dollar cost averaging helps eliminate the worry of catching the market at the right time. With dollar cost averaging, money is invested gradually, at regular intervals, into professionally managed portfolios. This allows the policyholder to take advantage of market highs and lows, buying more shares when the price is low and fewer shares when the price is high. A key benefit is that over time, the average per-unit cost will normally be lower than either the high or the average price.

Here is a simple example to illustrate how dollar cost averaging works. A person consistently invests $100 each month for three months. The investment chosen initially costs $10 per share. In the first month, this means 10 shares are bought. Then the next month, the market drops. This is not necessarily bad news. Even though the shares purchased last month for $10 are now only worth $8, one needs to remember that consistent $100 investments per month are being made. Because the price has dropped, the monthly $100 now buys 12.5 shares instead of 10.

Annualized Interest Rates and Fixed Account Bonuses- Bonus interest rates are extra amounts of interest granted to new purchasers of fixed-interest deferred annuities that are paid in addition to the normal stated current interest rate. These amounts are usually based on the total dollars contained in the contract during its first year. Bonus plan annuities are designed to attract money from existing annuity contracts, which still may be subject to a surrender charge, by paying extra interest in the first year. This extra interest (the bonus) is designed to offset some of the loss caused by the termination of the old policy. Potential purchasers must understand that these bonuses have an indirect cost behind them. Thus, the agent must be sure to tell prospects of any circumstance in which the bonus will not be paid, such as early termination or surrender. Interest rate bonuses often encourage replacement of annuities. The policyowner is lured by the high interest rate and a bonus above the normal current interest rate; the annuity owner may feel that the bonus will help to offset any surrender penalties he or she may incur. Bonus annuities will bear much higher surrender charges than a nonbonus product, putting the policyowner at a still greater disadvantage.

5. Death Benefit Guarantees

For variable annuities, the death benefit shall be at least equal to the cash surrender benefit. The cash surrender benefits are not to be less than the present value of that portion of the maturity value of the paid-up annuity benefit which would be provided under the contract at maturity arising from considerations paid prior to the time of cash surrender, reduced by prior withdrawals or partial surrenders of the contract. The present value is calculated on the basis of an interest rate not more than 1 percent higher than the interest rate specified in the contract for accumulating the net considerations to determine the maturity value, decreased by indebtedness including interest, and increased by any existing additional amounts credited by the company to the contract. Cash surrender benefit cannot be less than the minimum nonforfeiture amount. (Section 10168.4 of the CIC)

6. Living Benefit Guarantees

Insurance companies offer living benefits that give principal protection throughout the entire term of a variable annuity contract. The living benefits come in several forms:

- The guaranteed minimum income benefit, which guarantees a minimum level of income at annuitization
- The guaranteed minimum accumulation benefit, which guarantees a minimum account value at some point in the future
- The guaranteed minimum withdrawal benefit, which guarantees a minimum stream of income, equal to return of the variable annuity owner's principal, if withdrawn within specified limits over time.

E. Identify and Discuss Indexed Annuities

Two features that have the greatest effect on the amount of additional interest that may be credited to an equity-indexed annuity are the indexing method and the participation rate. It is important to understand the features and how they work together. The following describes some other equity-indexed annuity features that affect the index-linked formula.

Other features of equity index annuity contracts vary from product to product.
Premium Payments- The majority of products on the market are single premium deferred annuities, with the purchaser making one premium payment that is accumulated for some period prior to payout. Some insurers offer flexible premium deferred annuities, permitting multiple premium payments in amounts determined by the purchaser, and immediate annuities, providing for immediate commencement of the payout
Floor Guarantee- The guaranteed minimum return for a single premium product typically is 90% of premium accumulated at a minimum interest rate. Accumulation was at a 3% annual rate of interest, but as discussed in IV B 5 "Minimum Guaranteed Interest Rate" this is going to eventually change to a floating rate.

1. Primary Interest Crediting Strategies

The index-based return depends on the particular combination of indexing features specified in the contract. The return of equity index annuities is typically based on the S&P 500 Index, but other domestic and international indices are also used. Some products permit the contract owner to select one or more indices from a specified group of indices. Index growth generally is computed without regard to dividends. There are several methods for determining the change in the relevant index over the period of the contract. The most common indexing features are described below
The "point-to-point" method compares the level of the index at two discrete points in time, such as the beginning and ending dates of the contract term.
The "high water mark" or "look-back" method compares the highest index level reached on specified dates throughout the term of the contract (e.g., contract anniversaries) to the index level at the beginning of the contract term.
The "annual reset," "cliquet," or "lock-in" method compares the index level at the end of each contract year to the index level at the beginning of that year, with the gain for each year "locked in" even if the index declines in the following year. Averaging techniques may be used with these formulas to dampen the volatility of index changes. For example, in the point-to-point method, the ending index value could be computed by

averaging index values on each of the final 90 days of the contract term.

a. Monthly Averaging

This method uses the monthly closing market levels to determine the index level at the end of the contract term. The interest rate provides a return equal to the monthly average S&P of the previous year, times a participation rate which is then adjusted, as dictated under the contract, to be not less than zero- or other floor- nor higher than the CAP or maximum rate (say 14%). Suppose in year 1, the S&P goes up 20%- the client would get not 14% but about half that due to averaging. In the second year, the S&P did a -10%, but the client would just show no return at all due to the zero floor. In year 3, the S&P went up 20%- the client would get about 7%.

b. Point to Point

The point-to-point design credits interest based on the difference between the index value at the beginning and end of a period of at least one year. The change in the index is a "price change only" measure and does not reflect dividends. For example, the S&P 500 Index is at 900 and at the end of the crediting period the index result is 1,100. A gain of 22 percent is realized. The point-to-point design can be annual with an annual reset, or over a longer period of time, also known as a term point-to-point, that normally ranges from 7 to 12 years without a reset. The point-to-point term method works best in upward-trending markets over time, whereas the point-to-point with annual reset tends to work best in uncertain and volatile markets.

i. Annual

The annual point-to-point method calculates the interest return every contract year. It eventually combines these returns to arrive at the total return for the contract term. This method resets the starting point for the calculation each year on the contract anniversary and allows the owner to take advantage of economic upswing after a period of market loss or correction.

ii. Long-Term

The long-term point-to-point method compares the level of the index at two discrete points in time, such as the beginning and ending dates of the contract term in the point-to-point method, the ending index value could be computed by averaging index values on each of the final 90 days of the contract term. An example is 7 year, point-to-point, based on the S&P 500, using 6 month index averaging, with 80% participation, and a guaranty of 100% accumulating at 3%. Point-to-point methods credit interest as a portion of the percentage growth in the underlying index from the beginning of the term to the end of the term. Long term averaging may be used at the end of a multi-year point-to-point benefit determination, that is, when the index benefit is determined solely upon the change in the index from the beginning of the index term period to the end of the index term period, which could be up to ten years. Such averaging might be over a period of 2 to 24 months and commonly might use the average of monthly indices, Index-based interest is credited to the contract value either when it is calculated or at the end of the term. Interest in point-to-point contracts invariably is credited at the end of the term because its amount is unknown until then.

c. High Water Mark

This method of calculating the value of the index uses a fixed starting point to begin the computation. It does not reset the starting point of the index calculation periodically as other indexing methods might do. The annuity holder with this type indexing will only see positive interest appreciation when index levels are above the index point at the beginning. High water methods credit interest as a portion of the percentage growth in the underlying index from the beginning of the term to the highest value the index has achieved at specified measurement points up to the end of the term. Typically, these measurement points are the anniversaries in the contract, but they could occur with greater frequency. Each of these measurement points could use some averaging technique.

d. Annual Resets

This type of annuity calculation is also known as the ‘ratchet’ method. The annual reset design credit index-based interest to the current contract value on an annual basis. Most ratchets operate annually; however, less frequent application is possible.

e. Combination Methods

The following variations of the design are used for the reset/ratchet method. The discussion above pointed out other combinations.
Method of accumulation- A compound ratchet applies the index-based interest rate to the current contract value at the time of the crediting. A simple ratchet applies the index-based interest rate to the premium minus cumulative withdrawals at the time of the crediting.
Length of guaranty of index change recognition-.The current participation rate, spread charge, or cap can be guaranteed for the entire term, only for the current interest crediting period, or for some intermediate period. If the guaranty is only for the current interest crediting period, a lesser guaranty commonly is provided for the balance of the term and subsequent terms.
Annual averaging of index values within each year- This is used for ratchet designs to reduce the volatility in the interest credited to the contract. Another result is that a nominally higher portion of the calculated index increase rate is reflected in the interest rate. Methods used are daily averaging, monthly averaging, and quarterly averaging. These methods reflect on average half to slightly more than half of the annual index increase percentage; however, the portion will vary considerably from year to year depending upon the profile of the index volatility during the year. Ratchet Payment guaranties provide an increase over the most recent annuity payment if equity index based interest exceeds the assumed interest rate. This is analogous to a ratchet benefit in a deferred equity indexed annuity.

2. Spreads

In some annuities, the index-linked interest rate is computed by subtracting a specific percentage from any calculated change in the index. This percentage, sometimes referred to as the "margin," "spread," or "administrative fee," might be instead of, or in addition to, a participation rate. For example, if the calculated change in the index is

10%, the annuity might specify that 2.25% will be subtracted from the rate to determine the interest rate credited. In this example, the rate would be 7.75% (10% - 2.25% = 7.75%). In this example, the company subtracts the percentage only if the change in the index produces a positive interest rate.

3. Cap Rates

The cap rate operates to limit the amount of growth in the applicable market index that will be credited to the equity-indexed annuity. The cap is an upper limit on the amount of growth that can be passed on the annuity holder. The cap rate is expressed as a percentage. For example, an equity-indexed annuity with a participation rate (discussed in the next segment) of 100% might provide that a maximum of 12% of the gain in the index will be passed on to the value of the contract.

4. Participation Rates

In an equity-indexed annuity this is the amount or percentage of the increase in the market index that will be paid on the principal. The participation rate is a multiplier applied to the percentage increase in the index in order to determine the index-based interest rate. Participation rates are dependent upon interest rates and call option costs and, consequently, are determined separately at the beginning of each period during which they are guaranteed. The highest participation rates are for point-to-point products and lowest for ratchet products. In some contracts, the participation rate, frequently between 75% and 110%, is multiplied by index growth to determine the applicable share of index appreciation to be credited. The participation rate is typically set at the time the annuity is purchased and may be reset either annually or at the start of the next contract term. Other contracts specify a percentage, called the "margin" or "spread," that is subtracted from index growth to determine the applicable share of index appreciation to be credited.

5. Minimum Guaranteed Interest Rate

Equity-indexed annuity contracts provide a minimum guaranteed interest rate of 3% as prescribed by law. This eventually will change to a rate itself tied to an index that more realistically reflects interest rates in the economy.

6. Impact of Premature Surrender Charges

As with other annuity contracts, surrender charges apply if the indexed annuity contract is given up before a specified period of years. The idea is to make it less tempting for annuity owners to draw funds out of the contract and as well as to allow the insurer to recover costs associated with the contract. Surrender charges are commonly deducted from withdrawals, but these charges often are eliminated for a 30 to 45 day window at the end of each index term. There may also be a limited free withdrawal privilege.

a. Two-tier Annuities- Define Concepts

A two-tiered annuity is a type of fixed annuity in which the interest rate credited to the annuity depends on the distribution option. The insurer uses a lower interest rate if the owner chooses to convert the contract as a lump sum at some point. Contracts that annuitize and go into the payment stage are credited with a higher rate of interest. This is done to encourage the election of a periodic payout of the annuity.

A two-tier annuity differs from other annuities in that the annuitant cannot take a lump sum without giving up a considerable amount of return. To get the full value out of the annuity, the payout must be an income stream over the minimum number of years agreed upon in the contract with the insurance company. Because two-tier annuities are more restrictive in respect to liquidity than traditional annuities, insurers can invest premiums more freely, in less liquid investments or in investments with longer time projections for higher returns. All things equal, a two-tier annuity should yield higher returns than an identical annuity that does not require payouts as an income stream. The policyholder loses access to funds for the length of the income phase. The individual is locked in from the time of purchase of the contract through the deferral period.

7. Charges and Fees

A contract maintenance charge is ordinarily deducted each year from the value of an annuity. Other administrative charges can be deducted at an annual rate stated in the contract. This can amount to over 1% of the contract's value annually. Other charges can apply for the death benefit or any other options chosen at the time the contract is executed.

F. Available Riders

A rider is a written agreement attached to an insurance policy or annuity contract that limits or expands the policy's terms or coverage. Riders may increase the premium paid to the insurance company. Strictly speaking, a rider is documentation attached to an existing policy that augments or deletes from policy provisions. It is generally used to extend coverage for some specific reason. Endorsements are themselves often standardized. Basically, endorsements or riders are the documents used to shape the standardized policy to fit individual needs.

1. Life Insurance Rider

A life insurance rider would be just that. An increased, separate, amount would be paid for life insurance protection in some amount. Such insurance could feature an accelerated benefit option that allows for the early payment of some portion of the policy's face amount should the insured suffer from a terminal illness or injury. Any direct coupling of whole life insurance and an annuity contract would seem to fly in the face of the Supreme Court's decision in *Helvering v. Le Gierse*[9], where just such a coupling was decided to be a hedging or investment transaction, not insurance.

Tax-qualified term life- Tem life as a part of an annuity contract is considered incidental life insurance. If all of a person's 403(b) accounts invest only in mutual funds, then he or she has no incidental life insurance. If someone has an annuity contract, a portion of the cost of that contract may be for incidental life insurance. If so, the cost of

[9] (1941) 312 U.S. 53

the insurance is taxable to the individual in the year contributed and is considered part of the basis when distributed. The employer will include the cost of a person's insurance as taxable wages in box 1 of Form W-2. Not all annuity contracts include life insurance. If it does, the plan participant will need to figure the cost of life insurance each year the policy is in effect.

Figuring the cost of incidental life insurance. If it is determined that part of the cost of an annuity contract is for an incidental life insurance premium, he or she will need to determine the amount of the premium and subtract it from the includible compensation. To determine the amount of the life insurance premiums the individual will need to know the following information.

- The value of the life insurance contract, which is the amount payable upon the named insured's death.
- The cash value of the life insurance contract at the end of the tax year.
- The taxpayer's age on his or her birthday nearest the beginning of the policy year.
- The current life insurance protection under an ordinary retirement income life insurance policy, which is the amount payable upon death minus the cash value of the contract at the end of the year

2. Long-Term Care Benefits Rider

Annuities can have riders that meet a future need. An annuity with a long-term care rider that will pay for nursing home costs is an example of a rider that addresses a future concern. A long-term care rider fill the bill among consumers because it provides for two needs; provides the prospect of a stable retirement income while protecting against the financial risk associated with chronic long-term health problems. Many LTC riders are similarly constructed, providing coverage for catastrophic illnesses that require home health care, like an in-home nurse or aide, or long-term hospitalization, or a nursing home stay.

a. Terms of Riders

These riders are designed to provide benefits without cutting into the monthly payments received from an annuity. Thus, a long-term care rider on an annuity can provide great coverage in the event of an accident or unplanned illness. As with any added benefit, however, the cost can be a drawback. There can be minimum deposits required, sometimes ranging from $30,000 to $50,000 for the initial product purchase. Many annuities with long-term care riders require that the annuity be held for a certain term, such as 7-10 years. It is important that careful attention is given to how the contract defines "catastrophic" or "chronic" illness.

b. Difference Between Crisis Waivers & Long-Term Care Riders

Strictly speaking, a <u>waiver</u> is an intentional and voluntary surrender of some known right, which generally may either result from an express agreement or can be inferred from circumstances. It is the relinquishment of a known right that may result from either the affirmative acts of the insurer or its authorized agents, or from the insurer's nonaction, with knowledge of the applicable facts. In this case, the insured waives ownership rights to the policy in exchange for consideration (the early payment of cash).

Concerning endorsements or riders, these are written modifications of an insurance policy that change the original, often standardized, contract of insurance. Endorsements may broaden or narrow the original policy language. Strictly speaking, a rider is documentation attached to an existing policy that augments or deletes from policy provisions. It is generally used to extend coverage for some specific reason. Endorsements are themselves often standardized. Basically, endorsements or riders are the documents used to shape the standardized policy to fit individual needs. At least one form must be added to the insuring agreement and the terms and conditions in order to structure a complete contract. In this case, the addition is the long-term care coverage.

3. Skilled Nursing Facility Rider

A rider that adds skilled nursing facility benefits to the contract. The term "skilled nursing facility" refers to the level of skilled medical care required. Medicare.gov defines the term as; “A nursing facility with the staff and equipment to give skilled nursing care and, in most cases, skilled rehabilitative services and other related health services.”
The California Health and Safety Code defines the term like this;
"Skilled nursing facility" means a health facility that provides skilled nursing care and supportive care to patients whose primary need is for availability of skilled nursing care on an extended basis (California Health and Safety Code Sec. 1250).

4. Hospice Rider

This type of policy rider would offer hospice care, which is delivered in a person's home, or in a homelike setting. It is designed to meet the physical, emotional, and spiritual needs of those who are nearing death. Hospice care includes pain management, and focuses on working with the dying person's immediate family, the clergy, and the person's medical care providers.

5. Loan Provisions

It is difficult for many people to forecast their financial needs accurately for more than five to seven years in the future. Indexed annuity products impose surrender charges that start out as high as 15 to 20 percent and gradually decline over a surrender-charge period that is rarely less than seven years. Moreover, surrender during this period might also trigger forfeiture of premium bonuses and interest credits. To provide some liquidity and avoid the effects of early surrender, many indexed annuities provide for “free withdrawals” (up to an overall maximum) and these contracts also typically contain loan provisions that allow owners additional penalty-free access to accumulation values. If a person borrows money from his or her retirement plan, the loan must be treated as a nonperiodic distribution from the plan unless it qualifies for the exception explained below. This treatment also applies to any loan under a contract purchased under a retirement plan, and to the value of any part of the interest in the plan or contract that an individual pledges or assigns (or agree to pledge or assign). It applies to loans from both qualified and nonqualified plans, including commercial annuity contracts purchased directly from the issuer.

VI. Qualified and Non-Qualified Plans and Annuities

The U.S. individual annuity market is one component of the broader market for life insurance products. The American Council on Life Insurance (ACLI) reports that in 2016, premiums paid into all types of annuities totaled $346.7 billion. By comparison, premiums for group annuities totaled $124.4 billion.

A. Types of Plans

In this context 'plans' refers to retirement plans.
• A **qualified employee plan** is an employer's stock bonus, pension, or profit-sharing plan that is for the exclusive benefit of employees or their beneficiaries and that meets Internal Revenue Code requirements. It qualifies for special tax benefits, such as tax deferral for employer contributions and rollover distributions, and capital gain treatment or the 10-year tax option for lump-sum distributions (if participants qualify).
• A **nonqualified employee plan** is an employer's plan that does not meet Internal Revenue Code requirements for qualified employee plans. It does not qualify for most of the tax benefits of a qualified plan.

1. Defined Benefit

A traditional defined benefit plan is a plan in which the benefit on retirement is determined by a set formula, rather than depending on investment returns. It is any pension plan that is <u>not</u> a defined contribution plan. A traditional pension plan that *defines* a *benefit* for an employee upon that employee's retirement is a defined benefit plan. So, a plan that meets IRC requirements for qualified tax deductions. Nonqualified defined benefit plans are a form of deferred compensation, an example of which is the Supplemental Executive Retirement Plan (SERP).

Unlike a qualified plan, which is typically viewed as an agreement between an employer and a group of employees, a nonqualified plan is viewed as a collection of agreements between the employer and each individual employee. As a result, a violation of the terms of a nonqualified plan impacts only those participants affected by the violation, unlike a qualified plan where a violation of the plan’s terms with respect to just one employee can negatively affect all plan participants.

2. Defined Contribution

In a defined contribution plan, contributions are paid into an individual account for each member. The contributions are invested, for example in the stock market, and the returns on the investment (which may be positive or negative) are credited to the individual's account. On retirement, the member's account is used to provide retirement benefits, sometimes through the purchase of an annuity which then provides a regular income. Defined contribution plans are now the dominant form of plan in the private sector. The number of defined benefit plans in the US has been steadily declining, as more and more employers see pension contributions as a large expense avoidable by disbanding the defined benefit plan and instead offering a defined contribution plan.
As with defined benefit, a qualified plan is one that has IRS approval while a

nonqualified plan does not.

3. IRA (Individual Retirement Account)

Established by the Tax Reform Act (TRA) of 1986, an individual retirement account is held at a custodian institution such as a bank or brokerage, and may be investments can include certificates of deposits, stocks, or mutual funds. The only criterion for being eligible to contribute to an IRA is sufficient income to make the contribution. Transactions in the account, including interest, dividends, and capital gains, are not subject to tax while still in the account, but upon withdrawal from the account, withdrawals are subject to income tax. The original contribution amount in 1975 was limited to $1,500 or 15% of the wages/salaries/tips. The maximum amount allowed as an IRA contribution was $1500 from 1975 to 1981, rising to $2000 from 1982 to 2001. In 2018, under age 50 the maximum is $5,500 with $6,500 age 50 and above. The plan is for maximum contribution amounts to be adjusted for inflation in the future.

4. Roth IRA

In contrast to a traditional IRA, contributions to a Roth IRA are not tax-deferrable. Withdrawals are generally tax-free, but not always and not without certain stipulations (i.e., tax free when the account has been opened for at least 5 years for principal withdrawals and the owner's age is at least 59½ for withdrawals on the growth portion above principal). An advantage of the Roth IRA over a traditional IRA is that there are fewer withdrawal restrictions and requirements. Transactions inside the Roth IRA account (including capital gains, dividends, and interest) do not incur a current tax liability. The total contributions allowed per year to all IRAs is the lesser of taxable compensation and the limit amounts as of 2012 ($5,500 below age 50 and $6,500 for age 50 and above). As with the traditional IRA, future contribution limits will be assessed for a potential increase based on inflation.

5. TSA (Tax-Sheltered Annuity) (403(b))

A **tax-sheltered annuity** (TSA) plan (often referred to as a “403(b) plan” or a “tax-deferred annuity plan”) is a retirement plan for employees of public schools and certain tax-exempt organizations. Generally, a TSA plan provides retirement benefits by purchasing annuity contracts for its participants.
There are three benefits to contributing to a 403(b) plan.

- The first benefit is that taxes are not owed on allowable contributions in the year they are made. Taxes are not paid on allowable contributions until the plan participant begins making withdrawals from the plan, usually after retirement. Allowable contributions to a 403(b) plan are either excluded or deducted from income.
- The second benefit is that earnings and gains on amounts in the 403(b) account are not taxed until they are withdrawn.
- The third benefit is that for years beginning after 2001, the individual may be eligible to take a credit for elective deferrals contributed to the 403(b) account.

6. 401(k)

This type of retirement savings plan allows a worker to save for retirement and have the savings invested while deferring current income taxes on the saved money and earnings until withdrawal. The 401(k) plans are mainly employer-sponsored: employees elect to have a portion of their wages paid directly into their individual 401(k) account, which is managed by the employer. As a benefit to the employee, the employer can optionally choose to "match" part or all of the employee's contribution by depositing additional amounts in the employee's 401(k) account or simply offering a profit-sharing contribution to the plan.

Most 401(k) contributions are on a pre-tax basis. With either pre-tax or after-tax contributions, earnings from investments in a 401(k) account (in the form of interest, dividends, or capital gains) are tax deferred. The resulting compounding interest with delayed taxation is a major benefit of the 401(k) plan when held over long periods of time. Employees can either contribute on a pre-tax basis or opt to utilize the Roth 401 (k) provisions to contribute on an after-tax basis and have similar tax effects of a Roth IRA. For pre-tax contributions, the employee does not pay federal income tax on the amount of current income that he or she defers to a 401(k) account.

For example, a worker who earns $50,000 in a particular year and defers $3,000 into a 401(k) account that year only recognizes $47,000 in income on that year's tax return. Currently this would represent a near term $750 savings in taxes for a single worker, assuming the worker remained in the 25% marginal tax bracket and there were no other adjustments to income. The employee ultimately pays taxes on the money as he or she withdraws the funds, generally during retirement. Any gains (including tax favored capital gains) are transformed into "ordinary income" at the time the money is withdrawn.

7. SEP (Simplified Employee Pension Plan)

A SEP is a simplified employee pension plan. A SEP plan provides employers with a simplified method to make contributions toward their employees' retirement and, if self-employed, their own retirement. Contributions are made directly to an Individual Retirement Account or Annuity (IRA) set up for each employee (a SEP-IRA).

A SEP is established by adopting a SEP agreement and having eligible employees establish SEP-IRAs. There are three basic steps in setting up a SEP, all of which must be satisfied.

- A formal written agreement must be executed. This written agreement may be satisfied by adopting an Internal Revenue Service (IRS) model SEP.
- Each eligible employee must be given certain information about the SEP.
- A SEP-IRA must be set up for each eligible employee.

B. Annuities and Retirement Planning

Table 6-1 presents an overview of the significance of annuities in the U.S. insurance market. The table reports the premium income received by insurance companies for annuity policies over the 1977-2016 periods. The table shows both the substantial growth of real annuity premiums, and the breakdown of annuity premiums between individual and group policies. Although premiums on group policies were three to five times greater than the premiums on individual policies throughout the 1950s and 1960s, individual annuities grew rapidly in the last three decades of the 20th Century

Table 6-1: Payments into Annuities[1], by Year (millions)

Year	Individual Annuity	Group Annuity	Total[1]
1977	$4,552	$10,422	$14,974
1978	4,454	11,885	16,339
1979	4,976	12,963	17,939
1980	6,296	16,133	22,429
1981	10,290	17,289	27,579
1982	15,196	19,448	34,644
1983	14,003	16,541	30,544
1984	15,706	27,153	42,859
1985	20,891	33,008	53,899
1986	26,117	57,595	83,712
1987	33,764	54,913	88,677
1988	43,784	59,494	103,289
1989	49,507	65,590	114,997
1990	53,665	75,399	129,064
1991	51,671	71,919	123,590
1992	61,348	71,297	132,645
1993	76,987	79,458	156,445
1994	80,831	73,017	153,849
1995	77,370	82,565	159,935
1996	87,067	92,228	176,295
1997	90,192	107,355	197,547
1998	95,446	134,047	229,493
1999	115,621	154,591	270,212
2000	143,071	163,622	306,693
2001	141,656	109,599	273,930
2002	168,428	100,861	291,897
2003	165,943	102,614	290,369
2004	172,140	104,537	301,029
2005	167,032	110,084	302,596
2006	187,083	115,645	329,071
2007	192,503	121,722	341,344
2008	208,965	119,169	354,976
2009	128,853	102,727	255,633
2010	189,946	103,677	320,995
2011	217,837	117,058	359,142
2012	189,258	158,837	369,435
2013	179,578	108,091	307,260
2014	247,426	114,160	381,642
2015	208,913	124,103	352,363
2016	202,312	124,484	346,664

Source: American Council of Life Insurers

[1]Beginning with 2010, the total includes annuities certain and supplementary contracts.

By 1993, premiums for individual and group annuities were almost equal. This reflects both the decline in the growth of defined benefit pension and the rapid expansion of individual annuity products, particularly variable annuities. By comparison, life insurance premiums were $38.7 billion in 1951, more seven times greater than annuity premiums. Statistics such as those reported in Table 6-1 may actually understate the significance of annuity contracts. Virtually all permanent life insurance contracts other then term life accumulate cash value. This accumulated value can be used to purchase an annuity. Such policies are classified as life insurance policies, but they can also be viewed as partly annuity products. Provisions regarding withdrawals and annuity conversions are almost always specified in the life insurance policy at the time of purchase.

The difference in distribution channels between fixed and variable annuities is related to the nature of the product. Variable annuities are similar to stock market-based investments and appeal to different customers than those of fixed annuities. In addition, state and federal regulators require those who sell variable annuities to register with the National Association of Securities Brokers as securities dealers. Since 1995, banks have increased their share of fixed annuity sales. By contrast, career agents share fell.

Many Americans acquire annuity protection from their employers as a result of participation in a pension plan. When the employer agrees to provide retirement income, the income represents an annuity promise to the retiree. In addition to pension plans, privately purchased annuities may be obtained from life insurers. Annuities have come and gone from the public’s investing consciousness over the years.

An annuity is used to guarantee a steady stream of income and is often used to provide for retirement needs. Those who are not confident of their money management skills, and want the professional management provided by an insurer can also use the annuity. An annuity will maximize annual cash flow for those without dependents who are willing to liquidate their assets. Annuities have also been used in "structured settlements" in negligence cases. In these instances, instead of the defendant paying a lump sum to a plaintiff, the defendant (using the services of an insurer) promises a series of payments to the injured party. Annuities can also be used as a basic payout mechanism in that classic waste of the taxpayer’s money, the state-run lottery.

VII. Income Taxation- Qualified & Non-Qualified Annuities

The following section will discuss the application of income taxation of qualified and non-qualified annuities. Annuity taxation includes but is not limited to the following instances. The prudent insurance professional will remind the annuity-buying public that IRS publications or a tax professional should be consulted before contemplating tax strategy or completing tax returns

A. Payment of Premiums

For a non-qualified annuity, premiums paid into an annuity are not deductible. As a result, there is no current tax savings. Certain types of annuities may be deductible from income tax if certain requirements are met:

Individual Retirement Annuity- These contributions may be deducted by the owner if neither the husband nor wife participates in an employer provided retirement plan. Deductibility may still be allowable if either or both spouses participate in such a plan and their income meets certain limits.

Tax Sheltered Annuity- (often referred to as a “403(b) plan” or a “tax-deferred annuity plan”) This is a retirement plan for employees of public schools and certain tax-exempt organizations. Generally, a TSA plan provides retirement benefits by purchasing annuity contracts for its participants.

Qualified Employee Plan- This is an employer's stock bonus, pension, or profit-sharing plan that is for the exclusive benefit of employees or their beneficiaries and that meets Internal Revenue Code requirements. It qualifies for special tax benefits, such as tax deferral for employer contributions and rollover distributions, and capital gain treatment or the 10-year tax option for lump-sum distributions (if participants qualify). Premiums for a tax-qualified plan are tax deductible. An annuity contract may be held by a trust for a qualified plan. A qualified annuity plan must generally satisfy the same requirements as any other qualified plan.

B. Cash Value Accrual

Nonforfeiture legislation is intended to ensure that policyholders receive a fair value for their investment if they need to cash out of their annuity contract. The law mandates a 3% minimum guaranteed interest rate for fixed annuities. This minimum caused solvency concerns to emerge among insurers offering annuity products as interest rates drifted lower through the beginning of the 21st Century. Many of the investments of life insurers do not provide yields sufficient to support a 3% guaranteed yield. California AB 284 (2003) is legislation that addresses the issue. The bill provides a uniform method of calculating minimum nonforfeiture amounts. It sunsets the 3% interest rate applicable to accumulations under annuity contracts, the amounts by which those accumulations may be decreased, and the minimum amount of considerations used to determine the minimum nonforfeiture amount. If a contract provides for a settlement prior to the commencement of any annuity payments, the insurer can provide a paid-up annuity or a cash surrender benefit. (Section 10168.2 of the CIC)

C. Partial Withdrawals

Withdrawals from annuities may be made during the accumulation period or during the liquidation period.

Withdrawal Prior to Liquidation- If the annuitant funds a deferred annuity with a series of single premium deposits, or with level premiums, there will be a growing accumulation of funds prior to liquidation. In general, there is no federal income tax on the investment income earned on this accumulation unless there are total or partial withdrawals prior to age 59½. If an annuity owner withdraws funds during the accumulation period, the withdrawal is treated as if it is interest income, and it is subject to taxation as ordinary income. However, if the withdrawal is greater than all the investment income earned, the difference is treated as a return of principal. For example, assume Joan has deposited $5,000 in annuity premiums. Assume investment income has increased the value of her account by $2,000 so its total value is $7,000. Assume she withdraws $2,500. In the year of withdrawal, she must report $2,000 as ordinary income. The $500 is considered a return of capital. Moreover, after 1986 a 10 percent penalty tax is applied to the entire $2,500 withdrawal. Thus, if Joan makes a withdrawal prior to age 59½, she will pay the 10% penalty tax plus any additional ordinary income tax applicable.

Withdrawals in Liquidation

When the annuitant receives rent payments during the liquidation phase, part of the rent arises from the return of principal, as was noted earlier in the chapter. This part of the return is exempt from the income tax. The amount of the rent attributed to the return of principal is determined by an *exclusion ratio.* The mathematics of the exclusion ratio is covered in the sections describing income tax treatment. As an example of the favorable tax treatment of annuity withdrawals, assume David has paid $70,000 for an annuity. Over his expected lifetime he is to receive $100,000 in annuity rental payments from the insurer. (This figure would be calculated using IRS annuity tables.) In this case, David may exclude 70 percent of each payment, paying taxes only on the remaining 30 percent. Thus, if David receives $6,000 from his annuity in 1987, he reports only (.3 x $6,000) or $1,800 as taxable income. If his taxes are at a 28 percent marginal rate, he pays only (.28 x $1,800) or $504 in taxes on $6,000 in cash flow. Moreover, if David lives an exceptionally long life and receives much more than $100,000 from his annuity, he can continue to exempt from taxes 70 percent of each annuity rental receipt.

D. Loans and Assignments

Amount not received as an annuity- If a loan is received under an annuity contract, the amount received is treated as an amount not received as an annuity and included in current income. This is true whether the amount is received directly under the contract from the insurer or indirectly from another source. Any assignment or pledge of an annuity contract used to obtain a loan from a third party is considered to be an amount not received as an annuity.

Loans Treated as Distributions- If a person borrows money from his or her retirement plan, the loan must be treated as a nonperiodic distribution from the plan unless it qualifies for the exception explained below. Further, it applies if a person renegotiates, extends, renews, or revises a loan that qualified for the exception below if the altered loan does not qualify. The taxable part may be subject to the additional tax on early distributions. It is not an eligible rollover distribution and does not qualify for the 10-year tax option.

Exception for qualified plan, 403(b) plan, and government plan loans. At least part of certain loans under a qualified employee plan, qualified employee annuity, tax-sheltered annuity (TSA) plan, or government plan is not treated as a distribution from the plan. This exception applies only to a loan that either:

• Is used to buy an individual's main home, or
• Must be repaid within 5 years.

To qualify for this exception, the loan must require substantially level payments at least quarterly over the life of the loan. If a loan qualifies for this exception, it must be treated as a nonperiodic distribution only to the extent that the loan, when added to the outstanding balances of all the participant's loans from all plans of the employer (and certain related employers) exceeds the lesser of:

1) $50,000, or
2) Half the present value (but not less than $10,000) of the nonforfeitable accrued benefit under the plan, determined without regard to any accumulated deductible employee contributions.

E. IRS (Internal Revenue Service) Section 1035 Exchanges

Tax-free exchange-. No gain or loss is recognized on an exchange of an annuity contract for another annuity contract if the insured or annuitant remains the same. However, if an annuity contract is exchanged for a life insurance or endowment contract, any gain due to interest accumulated on the contract is ordinary income.

If a person transfers a full or partial interest in a tax-sheltered annuity that is not subject to restrictions on early distributions to another tax-sheltered annuity, the transfer qualifies for nonrecognition of gain or loss.

If the annuitant exchanges an annuity contract issued by a life insurance company that is subject to a rehabilitation, conservatorship, or similar state proceeding for an annuity contract issued by another life insurance company, the exchange qualifies for nonrecognition of gain or loss. The exchange is tax-free even if the new contract is funded by two or more payments from the old annuity contract. This also applies to an exchange of a life insurance contract for a life insurance, endowment, or annuity contract.

In general, a transfer or exchange in which a person receives ***cash proceeds*** from the surrender of one contract and invests the cash in another contract does not qualify for nonrecognition of gain or loss. However, no gain or loss is recognized if the cash distribution is from an insurance company that is subject to a rehabilitation, conservatorship, insolvency, or similar state proceeding. For the nonrecognition rule to apply the taxpayer must also reinvest the proceeds in a single contract issued by another insurance company and the exchange of the contracts must otherwise qualify for nonrecognition. He or she must withdraw all the cash and reinvest it within 60 days. If the cash distribution is less than required for full settlement, the annuitant must assign all rights to any future distributions to the new issuer.

F. Gift of an Annuity

For tax purposes, a gift occurs if property is transferred without full and adequate consideration. The transfer of ownership of an annuity contract is considered under the same standard. The new owner of the contract must recognize ordinary income to the extent of the excess of the contract's cash surrender value over the investment in the contract at the time of the transfer. If a nonqualifed annuity contract is not transferred and the gift consists only of annuity payments, the owner of the contract generally will remain taxable on the income from the annuity payments and may have to pay the gift tax on same. If transfer of the contract is made to a spouse or former spouse subject to a divorce, no gift is made. If the gift is an interest in a joint and survivor annuity where only the plan participant and spouse have the right to receive payments, the gift will generally be treated as qualifying for the unlimited marital deduction.

G. Sale of an Annuity by Owner

When a nonqualified annuity contract is sold a gain or loss is recognized. The seller considers any gain ordinary income. The new owner's investment in the contract equals the consideration paid to acquire the contract plus the value of premiums paid after the transfer. Subtracted from this total is any amount received by the new owner before the annuity starting date that was excluded from income.

H. Death of an Annuity Owner

The minimum values of any death benefit available as specified in the appropriate sections of the Insurance Code shall be based on minimum nonforfeiture amounts. As explained above in Section IV C. (Section 10168.2 of the CIC)

It is a matter of public policy that tax deferral treatment of annuities be limited. Annuities are to be used for retirement purposes and their use to achieve tax deferral beyond that time is discouraged by tax policy. There are two rules that affect annuity contracts in the event of death: The Death of the Holder Rule states that upon the death of a holder, death benefits of the annuity must and will be paid out. The "holder" is synonymous with the taxpayer/owner in any contract. In the case of a non-natural trust-owner, the annuitant is considered the owner, but only for death distributions. The Spousal continuation Rule [IRC 72(s)] states that the deceased owner's surviving spouse can become the contract owner. The surviving spouse can then continue the contract throughout his or her lifetime and is not forced to take a distribution. However, not all insurance annuity contracts offer the spousal continuation provision. If anyone else is named as a primary beneficiary along with the spouse, the option of the surviving spouse becoming the contract owner is usually lost. In cases where a child and spouse are named as primary beneficiaries, some companies will allow spousal continuation but only on the spouse's remaining portion of the contract. The IRC states only that the beneficiary be a spouse; however, some contracts specify that the spousal election letter will only be sent out if the surviving spouse is the "sole" beneficiary, which is a narrower interpretation of IRC.

1. Ordinary Income Tax Adjustment

If annuity funds are disbursed during the accumulation period, the withdrawal is treated as if it is interest income, and it is subject to taxation as ordinary income. However, if the withdrawal is greater than all the investment income earned, the difference is treated as a return of principal. For example, assume Joan has deposited $5,000 in annuity premiums. Assume investment income has increased the value of her account by $2,000 so its total value is $7,000. Joan meets an untimely death. For the year of death her estate must report $2,000 as ordinary income. The $5000 is considered a return of capital.

I. Death of Annuitant

If the annuitant and owner are the same person, when the annuitant dies so does the owner. The annuity is subject to distribution requirements as outlined in the previous section.

1. Ordinary Income Tax Adjustment

When the annuitant is someone else, and that person dies before the deferred annuity matures, the amount payable at his or her death is taxable as ordinary income to the beneficiary to the extent that payment exceeds principal paid in to the annuity contract. It is not considered in the same light as life insurance proceeds. If the beneficiary elects to receive the benefits in an installment option or as a life income, the regular annuity income rules (Simplified Method or General Rule) apply.

J. Annuity Benefits Distribution

This section explains how the periodic payments received from a pension or annuity plan are taxed. Periodic payments are amounts paid at regular intervals (such as weekly, monthly, or yearly) for a period of time greater than one year (such as for 15 years or for life). These payments are also known as ***amounts received as an annuity***. In general, an individual can recover the cost of their pension or annuity tax free over the period he or she is to receive the payments. The amount of each payment that is more than the part that represents cost is taxable.

1. Exclusion Ratio

Between the time the annuity is purchased and the time the contract owner receives payouts, no taxes are due on the dividends, capital gains, or interest earned by the assets in the annuity portfolio. When payouts are received, taxes are due on the difference between the annuity payouts and the annuitant's policy basis. The key tax principle is the derivation of an *exclusion ratio,* an estimate of the ratio of the annuitant's investment in the contract to the total expected payouts on the contract. The exclusion ratio is multiplied by the annuity payout in each period to determine the part of the payout that can be excluded from taxable income.

2. Tax-deferred Compounding

a. Computing Taxable vs. Tax-Deferred vs. Tax-Free Returns

The taxpayer figures the tax-free part of the payment using one of the following methods.

- ***Simplified Method.*** A person generally must use this method if his or her annuity is paid under a qualified plan (a qualified employee plan, a qualified employee annuity, or a tax-sheltered annuity plan or contract). He or she cannot use this method if their annuity is paid under a nonqualified plan.
- ***General Rule.*** One must use this method if his or her annuity is paid under a nonqualified plan. Generally, a taxpayer cannot use this method if the annuity is paid under a qualified plan.

Simplified Method

Under the Simplified Method, a person figures the tax-free part of each annuity payment by dividing the annuity cost by the total number of anticipated monthly payments. For an annuity that is payable for the lives of the annuitants, this number is based on the annuitants' ages on the annuity starting date and is determined from a table. For any other annuity, this number is the number of monthly annuity payments under the contract.

Who must use the Simplified Method. A taxpayer must use the Simplified Method if his or her annuity starting date is after November 18, 1996, and he or she meets *both* of the following conditions.

1) An individual receives a pension or annuity payments from any of the following qualified plans.
    a) A qualified employee plan.
    b) A qualified employee annuity.
    c) A tax-sheltered annuity (TSA) plan or contract.
2) On their annuity starting date, at least one of the following conditions applies;
    a) The person is under age 75.
    b) The person is entitled to fewer than 5 years of guaranteed payments.

Who cannot use the Simplified Method. An individual cannot use the Simplified Method if he or she received a pension or annuity from a nonqualified plan or otherwise do not meet the conditions described in the preceding discussion. See *General Rule,* later.

How to use it- The Simplified Method worksheet can be copied and used to figure a person’s taxable annuity for the current year. The taxpayer should keep the completed worksheet; it will help figure the taxable annuity for the next year. To complete line 3 of the worksheet, the taxpayer must determine the total number of expected monthly payments for the annuity. How a person does this depends on whether the annuity is for a single life, multiple lives, or a fixed period. For this purpose, treat an annuity that is payable over the life of an annuitant as payable for that annuitant's life even if the annuity has a fixed period feature or also provides a temporary annuity payable to the annuitant's child under age 25. The taxpayer does not need to complete line 3 of the worksheet or make the computation on line 4 if he or she received annuity payments the previous year and used that year's worksheet to figure the taxable annuity. Instead, enter the amount from line 4 of the previous year's worksheet on line 4 of the current year's worksheet.

Single life annuity- If an annuity is payable for one person's life alone, use Table 1 at the bottom of the worksheet to determine the total number of expected monthly payments. Enter on line 3 the number shown for the age of the subject individual on the annuity starting date. This number will differ depending on whether the annuity starting date is before November 19, 1996, or after November 18, 1996.

Multiple lives annuity*.* If the annuity is payable for the lives of more than one annuitant, use Table 2 at the bottom of the worksheet to determine the total number of expected monthly payments. Enter on line 3 the number shown for the annuitants' combined ages on the annuity starting date. For an annuity payable to the primary annuitant and to more than one survivor annuitant, combine the annuitant's age and the age of the youngest survivor annuitant. For an annuity that has no primary annuitant and is payable to an individual and others as survivor annuitants, combine the ages of the oldest and youngest annuitants. Do not treat as a survivor annuitant anyone whose entitlement to payments depends on an event other than the primary annuitant's death. However, *if the annuity starting date is before 199*8, do not use Table 2 and do not combine the annuitants' ages. Instead, the taxpayer must use Table 1 at the bottom of the worksheet and enter on line 3 the number shown for the primary annuitant's age on the annuity starting date. This number will differ depending on whether the annuity starting date is before November 19, 1996, or after November 18, 1996.

Fixed period annuity- If the annuity does not depend on anyone's life expectancy, the total number of expected monthly payments to enter on line 3 of the worksheet is the number of monthly annuity payments under the contract.

Example. Bill Kirkland, age 65, began receiving retirement benefits in 2002 under a joint and survivor annuity. Bill's annuity starting date is January 1, 2002. The benefits are to be paid for the joint lives of Bill and his wife, Kathy, age 65. Bill had contributed $31,000 to a qualified plan and had received no distributions before the annuity starting date. Bill is to receive a retirement benefit of $1,200 a month, and Kathy is to receive a monthly survivor benefit of $600 upon Bill's death. Bill must use the Simplified Method to figure his taxable annuity because his payments are from a qualified plan and he is under age 75. Because his annuity is payable over the lives of more than one annuitant, he uses his and Kathy's combined ages and Table 2 at the bottom of the worksheet in completing line 3 of the worksheet. His completed worksheet follows.

Simplified Method Worksheet

1. Enter the total pension or annuity payments received this year. Also, add this amount to the total for Form 1040, line 16a, or Form 1040A, line 12a		$14,400
2. Enter your cost in the plan (contract) at annuity starting date Note: *If your annuity starting date was before this year and you completed this worksheet last year, skip line 3 and enter the amount from line 4 of last year's worksheet on line 4 below. Otherwise, go to line 3.*		31,000
3. Enter the appropriate number from Table 1 below. But if your annuity starting date was after 1997 and the payments are for your life and that of your beneficiary, enter the appropriate number from Table 2 below		310
4. Divide line 2 by line 3		100
5. Multiply line 4 by the number of months for which this year's payments were made. If your annuity starting date was before 1987, enter this amount on line 8 below and skip lines 6, 7, 10, and 11. Otherwise, go to line 6		1200
6. Enter any amounts previously recovered tax free in years after 1986		-0-
7. Subtract line 6 from line 2		31,000
8. Enter the lesser of line 5 or line 7		1,200
9. **Taxable amount for year.** Subtract line 8 from line 1. Enter the result, but not less than zero. Also add this amount to the total for Form 1040, line 16b, or Form 1040A, line 12b Note: *If your Form 1099R shows a larger taxable amount, use the amount on line 9 instead.*		$13,200
10. Add lines 6 and 8		1,200
11. Balance of cost to be recovered. Subtract line 10 from line 2		$29,800

Table 1 for Line 3 Above
AND your annuity starting date was

If the age at annuity starting date was. . .	before November 19, 1996, enter on line 3	after November 18, 1996, enter on line 3
55 or under	300	360
56–60	260	310
61–65	240	260
66–70	170	210
71 or older	120	160

Table 2 for Line 3 Above

Combined ages at annuity starting date	Enter on line 3
110 and under	410
111–120	360
121–130	310
131–140	260
141 and over	210

Bill's tax-free monthly amount is $100 ($31,000 X 310 as shown on line 4 of the worksheet). Upon Bill's death, if Bill has not recovered the full $31,000 investment, Kathy will also exclude $100 from her $600 monthly payment. The full amount of any annuity payments received after 310 payments are paid must be included in gross income. If Bill and Kathy die before 310 payments are made, a miscellaneous itemized deduction will be allowed for the unrecovered cost on the final income tax return of the last to die. This deduction is not subject to the 2%-of-adjusted-gross-income limit.

General Rule

The IRS provides life expectancy tables to assist the taxpayer in computing the minimum required distribution amount. In general one can recover the net cost of the annuity tax-free over the period that he or she is to receive the payments. The amount of each payment that is more than the part that represents the net cost is taxable. Under the General Rule, the part of each annuity payment that represents net cost is in the same proportion that the investment in the contract is to the annuitant's expected return.

Expected Return

The expected return is the total amount the taxpayer and other eligible annuitants can expect to receive under the contract. The following discussions explain how to figure the expected return with each type of annuity. A person's age, for purposes of figuring the expected return, is the age at the birthday nearest to the annuity starting date.

Fixed period annuity- If a person expects to receive annuity payments for a fixed number of years, without regard to his or her life expectancy, the expected return must be figured based on that fixed number of years. It is the total amount to be received by the annuitant and other eligible annuitants beginning at the annuity starting date. Specific periodic payments are expected to be received for a definite period of time, such as a fixed number of months (but not less than 13). To figure the expected return, one should multiply the fixed number of months for which payments are to be made by the amount of the payment specified for each period.

Single life annuity- If annuity payments are to be received for the rest of the annuitant's life, find the expected return as follows. The person must multiply the amount of the annual payment by a multiple based on his or her life expectancy as of the annuity starting date. These multiples are set out in actuarial Table I, a portion of which is displayed at the end of this section. **Actuarial Tables I-VIII are available on line at the IRS website**, www.IRS.gov. These multiples may need adjustment if the payments are made quarterly, semiannually, or annually.

Example. Henry Martin bought an annuity contract that will give him an annuity of $500 a month for his life. If at the annuity starting date Henry's nearest birthday is 66, the expected return is figured as follows:

Annual payment ($500 × 12 months)	$6,000
Multiple shown in Table V, age 66	× 19.2
Expected return	$115,200

If the payments were to be made to Henry quarterly and the first payment was made one full month after the annuity starting date, Henry would adjust the 19.2 multiple by +.1. His expected return would then be $115,800 ($6,000 × 19.3).

Computation Under General Rule

Under the General Rule, the taxpayer figures the taxable part of the annuity by using the following steps:

Step 1. The amount of the investment in the contract should be figured, including any adjustments for the refund feature and the death benefit exclusion. This exclusion from income does not apply if someone is the beneficiary of an employee who died after August 20, 1996.

Step 2. Figure the expected return.

Step 3. Divide Step 1 by Step 2 and round to three decimal places. This will give the exclusion percentage.

Step 4. Multiply the exclusion percentage by the first regular periodic payment. The result is the tax-free part of each pension or annuity payment. The tax-free part remains the same even if the total payment increases or if the taxpayer outlives the life expectancy factor used. If the annuity starting date is after 1986, the total amount of annuity income that is tax free over the years cannot exceed the net cost. Each annuitant applies the same exclusion percentage to his or her initial payment called for in the contract.

Step 5. Multiply the tax-free part of each payment (step 4) by the number of payments received during the year. This will give the tax-free part of the total payment for the year. In the first year of the annuity, the individual's first payment or part of the first payment may be for a fraction of the payment period. This fractional amount is multiplied by the exclusion percentage to get the tax-free part.

Step 6. Subtract the tax-free part from the total payment which has been received. The rest is the taxable part of the pension or annuity.

Example 1. You purchased an annuity with an investment in the contract of $10,800. Under its terms, the annuity will pay you $100 a month for life. The multiple for your age (age 65) is 20.0 as shown in Table V. Your expected return is $24,000 (20 × 12 × $100). Your cost of $10,800, divided by your expected return of $24,000, equals 45.0%. This is the percentage you will not have to include in income. Each year, until your net cost is recovered, $540 (45% of $1,200) will be tax free and you will include $660 ($1,200 - $540) in your income. If you had received only six payments of $100 ($600) during the year, your exclusion would have been $270 (45% of $100 × 6 payments).

Example 2. Gerald Morris bought a joint and survivor annuity. Gerald's investment in the contract is $62,712 and the expected return is $121,200. The exclusion percentage is 51.7% ($62,712 ÷ $121,200). Gerald will receive $500 a month ($6,000 a year). Each year, until his net cost is recovered, $3,102 (51.7% of his total payments received of $6,000) will be tax free and $2,898 ($6,000 - $3,102) will be included in his income. If Gerald dies, his wife will receive $350 a month ($4,200 a year). If Gerald had not recovered all of his net cost before his death, his wife will use the same exclusion percentage (51.7%). Each year, until the entire net cost is recovered, his wife will receive $2,171.40 (51.7% of her payments received of $4,200) tax free. She will include $2,028.60 ($4,200 - $2,171.40) in her income tax return.

ACTUARIAL TABLES (Only a portion is shown, go to www.IRS.gov for complete Tables I-VIII)					
Table V.—Ordinary Life Annuities—One Life—Expected Return Multiples					
Age	**Multiple**	**Age**	**Multiples**	**Age**	**Multiple**
41	41.5	51	32.2	61	23.3
42	40.6	52	31.3	62	22.5
43	39.6	53	30.4	63	21.6
44	38.7	54	29.5	64	20.8
45	37.7	55	28.6	65	20.0
46	36.8	56	27.7	66	19.2
47	35.9	57	26.8	67	18.4
48	34.9	58	25.9	68	17.6
49	34.0	59	25.0	69	16.8
50	33.1	60	24.2	70	16.0

b. Long-term Effect of Tax-Deferred vs. Other Investment Choices

Annuities offer tax-deferred growth of savings. The overarching characteristic of an annuity is that it is a vehicle for distributing savings with a tax-deferred growth factor. A common use for an immediate annuity might be to provide a pension income. In the U.S., the tax treatment of a non-qualified immediate annuity is that every payment is a combination of a return of principal (which part is not taxed) and income (which is taxed at ordinary income rates, not capital gain rates). As pointed out in other sections of this book, other investment opportunities may offer a higher rate of growth, but it comes with higher risk.

K. Tax Effect on Estate

To determine the effect on a beneficiary, living or dead, it must first be understood whether the owner includes the annuity in his or her estate. This depends on whether the annuity is in the accumulation or distribution phase. In the accumulation phase, whether payable to the annuity holder or a third party beneficiary, the death benefit is included in the gross estate. In the annuitization phase, estate tax status is dependent on the type and terms of the contract. A straight life annuity leaves no residual value, thus nothing is included in the estate. If a settlement option is involved that included some sort of survivor benefit, the status of the benefit can vary.

Estate Tax Treatment of Annuities- The balance of a guaranteed amount is paid to a beneficiary when an annuitant dies. When this occurs, the payment is not taxable as income until the investment in the contract has been received tax free. The amount received by the beneficiary is added to the tax free amounts received by the annuitant. Only the amount received that exceeds the total amounts paid in will be taxable.
The annuity owned by a decedent may be subject to federal estate tax when any residual value is passed on to a survivor or beneficiary. Section 2039 of the Internal Revenue Code addresses estate taxation of annuities. It provides for a premium payment test to be used to determine value. The following guidelines are used:

- If the decedent did not pay any of the premiums, nothing will be included in the estate.

- When the decedent paid the premiums, all of the remaining annuity payments or benefits are includable in the gross estate of the annuitant.
- If only part of the premiums was paid by the deceased, only that part of the subsequent payments or benefits is includable in the decedent's gross estate. The same ratio as the value of premiums paid relative to the total value of premiums paid on the contract will be the determining factor.

Annuity benefits payable to the estate will be included in the gross estate. Any other amounts in question will be determined using the guidelines above. When annuity payments terminate at or before the annuitant's death, then no amount will be ascribed to the gross estate of the decedent. A person may be entitled to a deduction for estate tax if he or she receives a joint and survivor annuity that was included in the decedent's estate. The part of the total estate tax that was based on the annuity can be deducted, provided that the decedent died after his or her annuity starting date. It should be deducted in equal amounts over the remaining life expectancy of the survivor.

L. Disclaimer

See Attachment II (Section 789 of the CIC).
1. If a life agent offers to sell to a client any life insurance or annuity product, the life agent shall advise the client or the client's agent in writing that the sale or liquidation of this product may have tax consequences.
2. The life agent shall disclose that the client may wish to consult independent legal counsel or financial advice before buying, selling or liquidating any assets being solicited or offered for sale.
3. A life agent shall not provide detailed advice with issues surrounding income and estate taxation of annuities. If expert tax assistance is required, life agents shall advise client to consult with other professionals.

VIII. Advantages and Disadvantages

1. Advantages of Annuities

The purchase of an annuity is a good way to ensure a quality future. Like anything else, they have advantages and drawbacks. Also, when it comes to product marketing, the insurance professional may tend to stress only positives, and ignore the negative aspects of the product.

a. Advantages of Annuities for People Under 60

There are advantages to selection of an annuity as a retirement funding vehicle for people under 60 years of age;

- The value of an annuity will increase with time. The increase is a function of compounding of the principal and the value/frequency of periodic payments into the annuity account.
- There is tax-deferred growth and compounding of the money within the annuity contract.
- There is no restriction or bar for investing. Within reason, a worker can contribute what he or she wants, when they want.
- An annuity is a replacement for the rapidly-disappearing employer sponsored pension plan.
- Fixed-rate annuities are safe, with the principal guaranteed at all times.
- There is a guaranteed death benefit. In case of premature death of the contract holder, the principal is guaranteed. A variable annuity automatically contains a death benefit.
- Annuities are backed by the state guarantee fund. If the insurance company fails, the annuity owner does not lose principal.
- With a variable annuity, money transferred from one investment to another within the plan is tax free.

b. Advantages for People Age 60 and Older

Depending on a person's situation, the 'Under-60' advantages continue to apply after that age landmark is met. The age 60 is a milestone in annuities because of tax considerations.

- Annuities avoid the probate process. The value of the annuity is not included in the probate process since the annuity is not part of the gross estate. The beneficiary receives the death benefit associated with annuity from the insurance company.
- They are a steady source of income for people who feel that economic resources may be depleted over the time. Annuities solve the problem of an individual outliving his or her resources.

c. Surrender Charges

A surrender charge is imposed on partial and full withdrawals from an annuity contract for a period of years after the annuity is purchased. This charge is intended to make it less attractive for annuity owners to move funds An advantage to the surrender charge is that it will make people think twice before deciding to withdraw funds.

2. Disadvantages of Annuities for People Under 60

a. Disadvantages for People Under Age 60

Not everything is perfect with annuities, they have certain drawbacks.

- Inflation affects the fixed-payment nature of annuities. The fixed-payment nature of an annuity can cause purchasing power to erode over time
- A lump sum distribution can incur a significant tax burden. Generally, if someone is under age 59½ he or she must pay a 10% additional tax on withdrawals from a retirement account. The 10% additional tax applies to the part of the withdrawal that has been included in the individual's gross income. It is in addition to any regular income tax on that amount.

- Surrender charges are imposed by the insurance company if the annuity owner takes out a certain amount of money within a set number of years.
- Investment discipline is necessary. Funding an annuity requires either a large initial investment or multiple smaller investments over a period of time.
- A fixed annuity does not allow windfall investment gains like the stock market.

b. Disadvantages for People Age 60 and Older

The age 60 metric is all about the tax treatment of annuity withdrawals. Depending on individual circumstances, the disadvantages may apply to all age ranges.

- The funds in an annuity are not available for sudden and unanticipated expenses.
- An annuity (with the exception of a variable annuity) is a conservative investment and does not offer the flexibility and liquidity offered by certain other investments.
- A long-term planning horizon is part of the annuity. In order to work, an annuity requires a long time span and a significant amount of investment.

c. Surrender Charges

A surrender charge allows the insurance company to recover its costs if the contract does not remain in effect long enough. The surrender charge applies for a certain number of years; generally five to ten years after purchase. Typically the surrender charge percentage decreases with each passing year. Surrender charges are a disadvantage if emergency money is needed. It is difficult to determine how one will be situated financially five or ten years in the future.

3. Advantages and Disadvantages of Other Types of Investment Alternatives

Modern portfolio theory holds that diversification is important to minimizing overall risk. Investors should fill their portfolios with assets that yield returns with sufficiently different attributes from their other investments. That is, create a portfolio of assets that behave differently across market conditions. Doing so requires investors to seek out different types of assets with low correlation—a measure of the extent to which returns from different investments move together over time. Analysts and portfolio managers tend to consider investments with correlations of approximately 60 percent or less to provide diversification.

There are optional investments that offer different features than annuities. Depending on individual circumstances, annuity features may be seen as advantages or disadvantages when compared to other investment options. Here is a list of investment alternatives.

Certificate of Deposit (CD)

This financial product is a time deposit commonly offered to consumers by banks, thrift institutions, and credit unions. CDs are similar to savings accounts in that they are insured and thus virtually risk-free. CDs are insured by the FDIC for banks or by the NCUA for credit unions. They have a specific, fixed term (often three months, six months, or one to five years), and, usually, a fixed interest rate. It is intended that the CD be held until maturity, at which time the money may be withdrawn together with the accrued interest. Institutions usually grant higher interest rates than they do on accounts from which money may be withdrawn on demand. The opportunity of having a guaranteed interest rate for a set period of time gives the investor the advantage of being able to make a reasonable prediction on his return. Return predictability is an advantage annuities also offer.

The primary difference between the annuity and a certificate of deposit is that the interest earned on the certificate of deposit is taxable. The interest earned on the annuity is tax deferred, which long-term makes it the preferred option for investors over the certificate of deposit. The taxable nature of the certificate of deposit makes it a viable option for those investors who are concerned more with the availability of their investment in a shorter time frame.

Money Market

A money market fund is a type of mutual fund that is required by law to invest in low-risk securities. These funds have relatively low risks compared to other mutual funds and pay dividends that generally reflect short-term interest rates. Unlike a “money market deposit account” at a bank, money market funds are not federally insured. This is a disadvantage.

Differences between the money market account/fund and annuities is that interest earned on the money market account is taxable. The money market is short-term in nature. The interest earned on the annuity is tax deferred, which in the long run gives it an advantage over money markets. The money market is focused on the short term, with immediate access to funds. This is an advantage for investors who are concerned more with the availability of their investment in a short time frame.

Savings

These accounts are maintained by retail financial institutions and pay interest. Savings accounts let customers set aside a portion of their liquid assets while earning a monetary return. The basic savings account or passbook account will offer a very low interest rate. A typical basic savings account lets the account holder withdraw money whenever they want. Interest rates are low. The advantages and disadvantages are the same as with money markets and CDs.

Mutual Funds

A mutual fund is a professionally managed type of collective investment scheme that pools money from many investors and invests typically in investment securities. Mutual funds are easy to invest in and monitor. They offer professional management and several different investment options. Like annuities, a mutual fund account can be started with a few hundred dollars. Mutual funds and annuities have differences;

- Commissions- Most mutual funds charge some type of commission, which means 5-8% will be subtracted from the investment.
- Taxation- With mutual fund ownership, there are three potential sources of income tax; i) the dividends or interest generated by the portfolio, ii) the capital gains realized whenever the fund sells stocks, iii) profits resulting from the sale of shares.
- Withdrawal options- Like annuities, mutual funds allow withdrawals or liquidation at any time. Annuities offer options in which the annuitant cannot outlive the income stream.
- Safety- Mutual funds are prohibited from guaranteeing the rate of return or safety of principal. This is not so with annuities. For example, with a fixed-rate annuity, the rate

of return for each period, ranging from 1 to 10 years, is known. The guaranteed period is based on the option selected by the contract owner. Fixed-rate annuities guarantee principal is secure, variable annuities offer the guaranteed death benefit.

Mutual funds offer several advantages over investing in individual stocks. For example, the transaction costs are divided among all the mutual fund shareholders, which allows for cost-effective diversification. Investors may also benefit by having a third party (professional fund managers) apply expertise and dedicate time to manage and research investment options, although there is dispute over whether professional fund managers can, on average, outperform simple index funds that mimic public indexes. Whether actively managed or passively indexed, mutual funds are not immune to risks. They share the same risks associated with the investments made. If the fund invests primarily in stocks, it is usually subject to the same ups and downs and risks as the stock market.

Stocks

To have stock in a business is to have an ownership position. Used in the plural, the word *stocks* is often used as a synonym for *shares*. Shares represent a fraction of ownership in a business. A business may declare different types (*classes*) of shares, each having distinctive ownership rules, privileges, or share values. The Wall Street Journal reported that separately managed accounts (SMA or SMAs) performed better than mutual funds in 22 of 25 categories from 2006 to 2008. This included beating mutual funds performance in 2008, a tough year in which the global stock market lost US$21 trillion in value. (*SMA's Beat Funds in 2008*, I. Salisbury, Wall Street Journal 03/12/09; *Global Stock Market Losses Total $21 Trillion*, S. Thompson, London Times 02/11/09. In the story, Morningstar, Inc. said SMAs outperformed mutual funds in 25 of 36 stock and bond market categories. As with mutual funds, stocks differ from annuities in the area of commissions, taxation, withdrawal options and safety.

Bonds

Bonds and stocks are both securities, but the major difference between the two is that stockholders have an equity stake in the company, where bondholders have a creditor stake in the company. Another difference is that bonds usually have a defined term, or maturity, after which the bond is redeemed, whereas stocks may be outstanding indefinitely. A bond is a formal contract to repay borrowed money with interest at fixed intervals. The *issuer* is the borrower (debtor), the *holder* is the lender (creditor), and the *coupon* is the interest. Bonds provide the borrower with external funds to finance long-term investments, or, in the case of government bonds, to finance current expenditure. Certificates of deposit (CDs) or commercial paper are considered to be money market instruments and not bonds. Bonds must be repaid at fixed intervals over a period of time. Among the types of bonds available for investment are: U.S. government securities, municipal bonds, corporate bonds, mortgage- and asset-backed securities, federal agency securities and foreign government bonds. Many personal financial advisors recommend that investors maintain a diversified investment portfolio consisting of bonds, stocks and cash in varying percentages, depending upon individual circumstances and objectives. If someone can invest at the same yield and the same risk as the immediate annuity, are they not better off investing in the bonds versus buying the immediate annuity?

For many the answer will be "no," but making it an apples-to-apples comparison is more difficult than just comparing the interest income from the bonds with the income from the annuity. Additionally, getting the risk levels equal is nigh on impossible. Insurance departments have reserve and other requirements that make an investment in an annuity from a highly rated insurance company safer than an investment in a highly rated corporate bond.

Commodities

A commodity is a good for which there is demand, but which is supplied without qualitative differentiation across a market. It is fungible, i.e. equivalent no matter who produces it. Examples are petroleum, notebook paper, milk or copper. The price of copper is universal, and fluctuates daily based on global supply and demand. Commodity and futures contracts are based on what's termed forward contracts. Early on these forward contracts — agreements to buy now, pay and deliver later — were used as a way of getting products from producer to the consumer. These typically were only for food and agricultural products. Forward contracts have evolved and have been standardized into what are known today as futures contracts. Well-established physical commodities have actively traded spot and derivative markets. Generally, these are basic resources and agricultural products. Commodities are a 'zero sum game.' That is, in game theory and economic theory, **zero-sum** describes a situation in which a participant's gain or loss is exactly balanced by the losses or gains of the other participant(s). If the total gains of the participants are added up, and the total losses are subtracted, they will sum to zero. For an individual to make money with commodities, someone else must lose money, and vice-versa. Commodities' investing is a speculative endeavor. It is not a field in which to risk retirement funds.

Options

In finance, an option is a financial instrument that gives its owner the right, but not the obligation, to engage in some specific transaction on an asset. Options are derivative instruments, as their fair price derives from the value of the other asset, called the underlying. The underlying is commonly a stock, a bond, a currency, or a futures contract, though many other types of options exist, and options can in principle be created for any type of valuable asset. An option to buy something is a call; an option to sell is called a put. The price specified at which the underlying may be traded is called the strike price. Options are versatile instruments used for hedging strategies in financial transactions. This versatility, however, does not come without its costs. Options are complex securities and can be extremely risky. That is why, when trading options, disclaimers such as the following appear;

> Options involve risks and are not suitable for everyone. Option trading can be speculative in nature and carry substantial risk of loss. <u>Only invest with risk capital</u>. Retirement funds are not risk capital.

Limited Partnerships

A limited partnership is a form of partnership similar to a general partnership, except that in addition to one or more *general partners* (GPs), there are one or more *limited partners* (LPs). It is a partnership in which only one partner is required to be a general partner. Master Limited Partnerships (MLPs) are unique investments that combine the tax benefits of a limited partnership (LP) with the liquidity of common stock. An MLP has a partnership structure but issues investment units that trade on an exchange like common stock. In order to qualify, a firm must earn 90% of its income through activities or interest and dividend payments relating to natural resources, commodities or real estate. Tax implications for MLPs differ significantly from corporations for both the company and its investors. Like other limited partnerships, there is no tax at the company level. This effectively lowers an MLP's cost of capital, as it does not suffer the problem of double taxation on dividends. Companies that are eligible to become MLPs have a strong incentive to do so because it means a cost advantage over their incorporated peers. In an MLP, instead of paying a corporate income tax, the tax liability of the entity is passed on to its unitholders. Once a year, each investor receives a K-1 statement (similar to a 1099-DIV form) detailing his or her share of the partnership's net income, which is then taxed at the investor's individual tax rate. While the MLP's income is passed through to its investors for tax purposes, the actual cash distributions made to unitholders have little to do with the firm's income. Instead, cash distributions are based on the MLP's distributable cash flow (DCF), similar to free cash flow (FCF). Unlike dividends, these distributions are not taxed when they are received; instead, they are considered reductions in the investment's cost basis and create a tax liability that is deferred until the MLP is sold.

IRA Issues. Because MLPs generally don't pay tax on their earnings, the IRS doesn't want them held in an IRA, which is also tax deferred. Basically, this would be getting a double tax deferral on the money. Consequently, the distributions from MLPs are often subject to something called unrelated business taxable income if held in an IRA. There's a small exemption of about $1,000 a year. In general, MLPs should not be held in an IRA or other type of tax qualified account.

Diversify. MLPs are just one of many investments to consider when building income streams for retirement, such as other dividend paying stocks and high-quality fixed income holdings. Because MLPs tend to be concentrated in the natural resources industry, the price and the distributions can be volatile.

Opportunity. MLPs offer good income opportunities but are complicated from a tax perspective. If one is going to venture into them, it should only be considered with the guidance of an accountant and financial professional.

Promissory Notes

These are referred to as a **note payable** in accounting, or commonly as just a "note." It is a contract where one party (the *maker* or *issuer*) makes an unconditional promise in writing to pay a sum of money to the other (the *payee*), either at a fixed or determinable future time or on demand of the payee, under specific terms. They differ from IOUs in that they contain a specific promise to pay, rather than simply acknowledging that a debt exists. These notes are purchased/traded at a discount as a way to factor in the possibility on non-payment. Two problems present themselves already; how much of a discount cannot be determined without work and expertise. "Non-payment" is never a good thing to hear when retirement money is at stake. An unscientific look at the Internet turns up "promissory note" juxtaposed with the word "scam" more often than not. This is neither an advantage nor a good way to start up with retirement money.

Real Estate Investment Trust (REIT)

This type trust is a tax designation for a corporation investing in real estate that reduces or eliminates corporate income taxes. In return, REITs are required to distribute 90% of their income, which may be taxable, into the hands of the investors. The REIT structure was designed to provide a similar structure for investment in real estate as mutual funds provide for investment in stocks.

It may be prudent to invest a portion of retirement savings in REITs as part of an overall strategy to improve portfolio performance by enhancing its diversification. Research has shown that adding REITs to an already-diversified portfolio may increase returns without increasing volatility (Portfolio Diversification Through REITs, The Ibbotson Analysis, for National Association of Real Estate Investment Trusts, 2006). A strategy of holding the

REIT investments long-term is assumed. The dividend distribution can be a plus for investor’s retirement portfolio. However, the dividends can be cut in lean times and that is what happened as a result of the subprime lending mania which peaked in 2006. In addition, a December 2008 revenue procedure from the IRS gave REITS the option of paying out up to 90% of their dividends in stock rather that cash (This revenue procedure was later extended). Receipt of stock in lieu of cash is a viable option during the accumulation phase of the retirement process but it is a disadvantage for retirees needing cash

Viatical Settlements

A viatical settlement the sale of a life insurance policy by the policy owner before the policy matures. Such a sale, at a price discounted from the face amount of the policy but usually in excess of the premiums paid or current cash surrender value, provides the seller an immediate cash settlement. Generally, viatical settlements involve insured individuals with a shorter life expectancy.

When an individual decides to put his or her money into this type of investment, it is critical that there is an understanding of the risks involved, how the investment will be used, and what the likely return will be;

- A viatical settlement is not a liquid investment; there is no “cash in” of principal if the investor changes their mind. There is no return on investment until the insured dies and the death benefit is paid.
- There is no guaranteed annual rate of return. The rate of return depends on when the insured dies and no one can perfectly predict a person’s life expectancy. The investor should find out the life expectancy of the insured and how that determination was made.
- The possibility exists that individuals who sell their policies in a viatical settlement may not have a life-threatening illness. They may be selling the policy because they can’t afford it or no longer need it.
- Through operation of the Incontestable Clause of a life insurance policy, insurance companies may refuse to pay death claims for policies less than two years old. In the first two years, the death benefit could be denied for various reasons including suicide or false medical information.
- Because Internal Revenue Code Section 408(a)(3) requires that no part of the trust funds of an individual retirement account may be invested in life insurance contracts, the Internal Revenue Service may disallow viatical settlement contracts held as investments inside IRA's.
- If an investment in a viatical settlement contract is made with qualified retirement plan funds, the investor may have difficulty taking the mandatory distributions beginning at age 70 1/2 because liquid funds may not be available from the plan's investments.

When investing in a life insurance policy the premiums must be paid until the insured dies. Investors should determine who is responsible for paying the premiums and whether the investor could ever be responsible for paying the premiums. For example, if the insured lives longer than expected will the investor be required to pay the premiums? If so, this will decrease the rate of return.

IX Sales Practices for California Agents

A. Required Insurance Producer Product Training

Before effecting any sales efforts, insurance producers otherwise allowed to engage in the sale of annuities must complete a one-time eight credit-hour approved annuity training course offered by an approved continuing education provider. The course can be either classroom or self-study. Additionally, California producers who sell annuities are to complete four continuing education credits prior to license renewal every two years. Training required for the eight-hour course includes all the topics included in this book, which follows the prescribed outline provided by the California Department of Insurance. None of the following information is to be presented; marketing information, training on sales techniques, or specific information about a particular insurer's products. Additional topics may be offered in conjunction with and in addition to the required outline.

Providers of annuity training are to issue certificates of completion to students and report course completions as required. Insurers are to verify that insurance producers have completed required annuity training before allowing them to sell an annuity product. An insurer may satisfy its responsibility by obtaining certificates of completion of the training course or obtaining reports provided either by the Department of Insurance or ancillary vendors (Section 10509.915(b) of the CIC).

B. Describe the Rights and Obligations of the Insurance Producer at Contract Inception

1. Required Disclosures

If an insurance agent offers to sell any life insurance or annuity product to someone age 65 or over, the agent is required to give written notice to the potential purchaser that the sale or liquidation of any stock, bond, IRA, certificate of deposit, mutual fund, annuity, or other asset to fund the purchase of life insurance and/or an annuity, may have tax consequences, early withdrawal penalties, or other costs or penalties as a result of the sale or liquidation. Before purchasing a life or annuity product, consumers should seek independent legal or financial advice. The same can be said about selling or liquidating any assets. This disclosure requirement does not apply to credit life. Financial products sold on the basis of their Medi-Cal program treatment cannot misstate asset treatment under Medi-Cal as it relates to the determination of the elder's eligibility for public assistance. Financial products sold on the basis of their treatment under the Medi-Cal program must provide a disclosure form (see Attachment II for the disclosure form) to the elder or the elder's duly appointed representative. (Section 789.8 of the CIC)

2. Product Specific Illustrations (e.g. Sales Aids)

Any time nonpreprinted illustrations of nonguaranteed values are used in the course of a sales function, the insurer and selling agent must disclose on those illustrations or on an attached cover sheet, in a prominent manner the following statement:

"THIS IS AN ILLUSTRATION ONLY. AN ILLUSTRATION IS NOT INTENDED TO PREDICT ACTUAL PERFORMANCE. INTEREST RATES, DIVIDENDS, OR VALUES THAT ARE SET FORTH IN THE ILLUSTRATION ARE NOT GUARANTEED, EXCEPT FOR THOSE ITEMS CLEARLY LABELED AS GUARANTEED."

Preprinted policy illustrations must also contain this notice in 12-point bold print with at least one-half inch space on all four sides, printed on the illustration form itself or on an attached cover sheet, or in the form of a contrasting color sticker placed on the front of the illustration. All preprinted illustrations containing nonguaranteed values shall show the columns of guaranteed values in bold print. All other columns used in the illustration shall be in standard print. "Values" as used here includes cash value, surrender value, and death benefit. (Section 10127.11 of the CIC)

3. Replacement

Along with each application for life insurance or an annuity accepted by an agent, he or she will submit to the insurer both of the following:

1.) A statement signed by the applicant as to whether replacement of existing life insurance or annuity is involved in the transaction.
2.) A signed statement as to whether or not the agent knows replacement is or may be involved in the transaction.

If a replacement is involved, the agent must present to the prospective insured by the time of receipt of the application, the following notice.

NOTICE REGARDING REPLACEMENT REPLACING YOUR LIFE INSURANCE POLICY OR ANNUITY?

Are you thinking about buying a new life insurance policy or annuity and discontinuing or changing an existing one? If you are, your decision could be a good one--or a mistake. You will not know for sure unless you make a careful comparison of your existing benefits and the proposed benefits. Make sure you understand the facts. You should ask the company or agent that sold you your existing policy to give you information about it.

Hear both sides before you decide. This way you can be sure you are making a decision that is in your best interest.

We are required by law to notify your existing company that you may be replacing their policy.

____________________ ____________________ ____________________

(applicant) (agent) (date)

This notice must be signed by both the applicant and the agent and left with the applicant. A list of all existing life insurance or annuities to be replaced and properly identified by name of insurer, the insured and contract number is to be obtained. Agents are to leave with the applicant the original or a copy of all printed communications used for presentation to the applicant. Agents must submit to the replacing insurer with the application a copy of the replacement notice. (Section 10509.4 of the CIC)

A violation of the Insurance Code occurs if an agent or insurer recommends the replacement or conservation of an existing policy by use of materially inaccurate information or recommends that an insured 65 years of age or older purchase an unnecessary replacement annuity. "Unnecessary replacement" means the sale of an annuity to replace an existing annuity that requires that the insured will pay a surrender charge for the annuity that is being replaced and that does not confer a substantial financial benefit over the life of the policy to the purchaser so that a reasonable person would believe that the purchase is unnecessary. Patterns of action by policyowners who purchase replacement policies from the same agent after indicating on applications that replacement is not involved, shall constitute a rebuttable presumption of the agent's knowledge that replacement was intended in connection with the sale of those policies, and such patterns of action shall constitute a rebuttable presumption of the agent's intent to violate this article. There is no prohibition against the use of additional materials that are not in violation of statute or regulation. (Section 10509.8 of the CIC)

4. Importance of Reviewing Sample Contracts

Sample contracts are essential to the potential insured's understanding of the contractual relationship existing between insured and insurer. The insurer must make certain that the sales force is knowledgeable about contract terms and conditions and has up-to-date contract instruments at their disposal. The terms of the contract must be spelled out and potential insured made to understand that what is written down, that which is signed, is the contract. Verbal modifications and assurances are unenforceable. As Hollywood mogul Samuel Goldwyn once said, "verbal agreements… are not worth the paper they are written on."

C. Appropriate Advertising

An insurance advertisement is defined very broadly in as any communication directly or indirectly related to a policy and intended to result in the eventual sale or solicitation of a policy. Advertisements include but are not limited to:

Printed or published materials	Radio & TV	Prepared sales talks
Newspapers & magazines	Billboards	Websites/E-mail
Representations by agents	Leaflets	Descriptive literature
Circulars	Sales aids	Flyers
Illustrations	Form letters	Direct mail
Business cards	Videos	Faxes

1. General Advertising

a. Definition of advertisement

The term 'advertising' for the purpose of this discussion of the California Insurance Code includes envelopes, stationery, business cards, or other materials designed to describe and encourage the purchase of a policy or certificate of disability insurance, life insurance, or an annuity.

No advertisement can employ words, letters, initials, symbols, or other devices that are so similar to those used by governmental agencies, a nonprofit or charitable institution, senior organization, or other insurer that they could have the capacity or tendency to mislead the public. Examples of misleading materials, include, but are not limited to, those which imply any of the following:

- The advertised coverages are somehow provided by or are endorsed by any governmental agencies, nonprofit or charitable institution or senior organizations.
- The advertiser is the same as, is connected with, or is endorsed by governmental agencies, nonprofit or charitable institutions or senior organizations.

Advertisements used by agents, producers, brokers, solicitors, or other persons for a policy of an insurer must have the written approval of the insurer before they may be used. These ads must contain the agent’s name, business address, telephone number, and any insurance license number in type the same size as other information displayed. The word "Insurance" is to be displayed in type size no smaller than the largest indicated telephone number. The agent's license number must also be in type size no smaller than any displayed telephone number (Section 1725.5 of the CIC).

b. Seminars, Classes, Informational Meetings

Beyond any other prohibition on untrue, deceptive, or misleading advertisements, the following protocol must be followed when soliciting seniors in a group; In advertisements for an event where insurance products will be offered for sale, if the terms "seminar," "class," "informational meeting," or some equivalent term is used to characterize the purpose of the public gathering, the words "and insurance sales presentation" must be used immediately following those terms in the same type size and font as those terms. Each person attending a meeting with a senior shall provide the senior with a business card or other written identification stating the person's name, business address, telephone number, and any insurance license number.
(Section 787(k) of the CIC)

c. Direct Mailers

If a company or insurance producer uses direct mailings, this is considered to be a device designed to produce leads based on a response from a person. Since respondents may be 65 years of age or older, these mailers must prominently disclose the fact that an agent may contact the senior. (Section 787of the CIC)

d. Advertising Proscriptions

Here is a list of practices in which insurers must not engage when soliciting business;
Advertising may not use the name of a state or political subdivision of a state in a policy name or description.
In the same manner, it is prohibited to use any name, service mark, slogan, symbol, or device in such a way as to imply that the insurance company or its representative is connected with a governmental agency, such as the Social Security Administration.
Advertising may not imply that the reader may lose a right, or privilege, or benefits under federal, state, or local law if the prospect fails to respond to the advertisement.

The insurance company or its representative is prohibited from using an address so as to mislead or deceive as to the true identity, location, or licensing status of the insurer, agent, broker, or other entity.
In the trade name of its insurance policy or certificate, insurers cannot use any terminology or words so similar to the name of a governmental agency or governmental program as to have the capacity or the tendency to confuse, deceive, or mislead a prospective purchaser. (Section 787(b) of the CIC)

e. Fines and Penalties

Violations of advertising regulations are subject to fines. The first offense is $200, $500 for the second offense, and $1,000 for subsequent offenses. The penalty shall not exceed one thousand dollars ($1,000) for any one offense. These fines shall be deposited into the Insurance Fund. (Section 1725.5 (d) of the CIC)

2. Advertising for Persons 65 Years and Older

Advertisement or other device designed to produce leads based on a response from a potential insured which is directed at people age 65 or older is must display and disclose in a prominent manner that an agent may contact the applicant if such is the case. Additionally, an agent who makes contact with a prospective insured as a result of acquiring that person's name from a lead generating device needs to make this fact known to the prospective in the initial contact with the person. Insurance companies and their representatives in California must not solicit anyone age 65 and older for the purchase of disability insurance, life insurance, or annuities through the use of a true or fictitious name which is deceptive or misleading with regard to the status, character, or proprietary or representative capacity of the entity or person, or to the true purpose of the advertisement. (Sec. 787 of the CIC)

D. Prohibited Sales Practices

1. Selling Annuities for Medi-Cal Eligibility

Annuities cannot be sold to a senior as a means of facilitating eligibility for Medi-Cal. The sale is void if any of the following conditions result from the sale;

a. Selling to Persons 65 and Older

The purchaser's assets are less than or equal to the statutorily determined community spouse resource allowance ($123,600 as of 01/01/2018) established annually by the State Department of Health Care Services.
The purchaser of the annuity would otherwise qualify for Medi-Cal.
The senior's purpose in purchasing the annuity is to affect Medi-Cal eligibility (to become Medi-Cal eligible) and, after the purchase of the annuity, the senior or the senior's spouse does not qualify for Medi-Cal.

If any of the conditions above be true and a fixed annuity is issued to an individual, the issuer shall rescind the contract and refund to the purchaser all premiums, fees, any interest earned under the terms of the contract, and costs paid for the annuity. This remedy shall be in addition to any other remedy that may be available. (Section 789.9 of the CIC)

2. In-Home Solicitations

a. Criteria

In connection with the activities surrounding the sale of annuities to seniors (this includes sale, offering for sale, or generation of leads for the sale of life insurance, including annuities to persons 65 or older), Any agent who meets with a senior in the senior's home is required to deliver a notice in writing to the senior no less than 24 hours prior to that individual's initial meeting in the senior's home.

b. Content of Written Notice

If the senior has an existing insurance relationship with an agent and requests a meeting with the agent in the senior's home the same day, a notice shall be delivered to the senior prior to the meeting. The notice shall be in substantially the following form, with the appropriate information inserted, in 14-point type:

During this visit or a follow-up visit, you will be given a sales presentation on the following (indicate all that apply):

( ) Life insurance, including annuities
( ) Other insurance products (specify): _________________.

You have the right to have other persons present at the meeting, including family members, financial advisors or attorneys.

You have the right to end the meeting at any time.

You have the right to contact the Department of Insurance for information, or to file a complaint. (The notice shall include the consumer assistance telephone numbers at the department)

The following individuals will be coming to your home: (list all attendees, and insurance license information, if applicable)

___________________ ____________________ ____________________

Upon contacting the senior in the senior's home, the person shall, before making any statement other than a greeting, or asking the senior any other questions, state that the purpose of the contact is to talk about insurance, or to gather information for a follow-up visit to sell insurance, if that is the case, and state all of the following information:
The name and titles of all persons arriving at the senior's home.
The name of the insurer represented by the person, if known.

Each person attending a meeting with a senior shall provide the senior with a business card or other written identification stating the person's name, business address, telephone number, and any insurance license number. The persons attending a meeting with a senior shall end all discussions and leave the home of the senior immediately after being asked to leave by the senior.

c. True Content of Meeting

A person may not solicit a sale or order for the sale of an annuity or life insurance policy at the residence of a senior, in person or by telephone, by using any plan, scheme, or ruse that misrepresents the true status or mission of the contact. (Section 789.10 of the CIC)

3. Sharing Commissions with Attorneys

A member of the insurance sales force, be it an agent, broker, or solicitor, who is not an active member of the State Bar of California may not share a commission or other compensation with an active member of the State Bar of California. The phrase "commission or other compensation" should be considered to include pecuniary or nonpecuniary compensation of any kind relating to the sale or renewal of an insurance policy or certificate or an annuity, including, but not limited to, a bonus, gift, prize, award, or finder's fee. (Section 1724 of the CIC)

4. Unnecessary Replacement

a. Unnecessary Replacement Defined

It is a violation of the California Insurance Code to recommend replacement of an existing policy to someone 65 or older by using an inaccurate presentation or comparison of an existing contract's economic value.

The term "unnecessary replacement" in this context means selling an annuity to replace an existing annuity. Replacement is unnecessary if;

- The insured pays a surrender charge for the annuity being replaced.
  And
- The new contract does not confer a substantial financial benefit over the life of the policy to the purchaser so that a reasonable person would believe that the purchase is unnecessary (Section 10509.8 of the CIC).

Consumer Suitability

The agent must reasonably believe that the replacing product is suitable for the consumer. Before concluding an annuity transaction, the producer or insurer is to make reasonable efforts to obtain the consumer's suitability information. Belief should be based on the consumer's financial and suitability information. The producer should have reason to believe:

- The consumer has been reasonably informed of various features of the annuity, such as fees, charges and risk.
- The consumer would receive a tangible net benefit from the transaction.
- That the annuity as a whole, subaccounts, riders and enhancements are suitable.
- That an exchange or replacement is suitable, including the following:
  - Whether the consumer will incur a surrender charge or be subject to the

commencement of a new surrender period.
    - Whether the consumer would benefit from product enhancements and improvements.
    - Whether the consumer had another exchange or replacement within the preceding 60 months.

There is no agent obligation related to an annuity transaction if any of the following occur:
- No recommendation is made.
- A recommendation was made based on inaccurate consumer information.
- Suitability information is not provided by the consumer and the annuity transaction is not recommended.
- A consumer decides to enter into an annuity transaction that is not based on a recommendation of the insurer or the insurance producer.

An insurer's issuance of an annuity subject to the terms above is considered reasonable. To cover all the bases, at the time of sale the agent should:
- Make a record of any product recommendation relevant to the sale.
- Obtain a customer-signed statement documenting the customer's refusal to provide suitability information.
- Obtain a customer-signed statement that an annuity transaction is not recommended if the customer decides to enter into an annuity transaction that is counter to the agent's recommendation.

Insurers should establish a supervision system reasonably designed to achieve the insurer's and producers' compliance with mandates on insurance suitability. The supervision system should include:
- Procedures to inform producers of the pertinent requirements listed here.
- Standards for insurance producer product training and compliance.
- Product-specific training and materials.
- Procedures for review of each recommendation prior to issuance of an annuity.
- Methods to detect recommendations that are not suitable.
- System audit features.

Third-party vendors can be used to administer/monitor the compliance system if the contractor is monitored and management certifies the contract function.

Consumers must not be dissuaded from or talked out of any of the following:
- Truthfully responding to an insurer's request for confirmation of suitability information
- Filing a complaint
- Cooperating with the investigation of a complaint

All the mandates and proscriptions outlined in the section above apply to Financial Industry Regulatory Authority (FINRA) broker-dealer sales of variable and fixed annuities (Section 10509.914 of the CIC).

b. Examples of unnecessary replacement

A replacement annuity contract is one where the purchase results in the lapse, forfeiture, or surrender of part of all of an existing annuity contract or life insurance policy. As discussed in this section, there are regulations that require certain procedures to be followed before the issuance of a replacement annuity contract.

An example of unnecessary replacement is the unnecessary replacement of an older policy and using its cash value to pay for a brand new policy. An insurer may try to push the sales force to sell more of the company's proprietary products. While management is not saying, "switch," they are not saying "don't switch." Agents may be subjected to sales meetings given by insurers or wholesalers and strongly encouraged to move policies that are part of ‘the system.’ If business is slow, it may be hard for agents to overlook who is paying the biggest commissions or can promise entrée to more business.

The personal finance sector is constantly changing, and consumers are regularly approached and urged to re-assess their investment and insurance portfolios. This regularly results in changes to the existing portfolios being proposed and often the consumer does not know whether a change is really beneficial or not. Sometimes a new product tends to look as if it is more beneficial at first sight. For example, a replacement policy may offer a tempting short-term teaser rate, but contain restrictive withdrawal and surrender features. It is always advisable to contact the insurer or intermediary from whom the original product was obtained and check whether the new product is in reality more beneficial. In terms of policyholder protection, the insured should consider details of any commission earned by the person selling the policy. Where a senior is being advised to replace an annuity policy, it is important to think about the details of any commission paid by the insurer, as well as any up-front or ongoing fees which the agent earns from the new product provider.

c. Replacement of annuities Including Individuals 65 Years of Age and Older

A violation of the Insurance Code occurs if an agent or insurer recommends the replacement or conservation of an existing policy by use of materially inaccurate information or recommends that an insured 65 years of age or older purchase an unnecessary replacement annuity. "Unnecessary replacement" means the sale of an annuity to replace an existing annuity that requires that the insured will pay a surrender charge for the annuity that is being replaced and that does not confer a substantial financial benefit over the life of the policy to the purchaser so that a reasonable person would believe that the purchase is unnecessary (Section 10509.8 of the CIC).

5. Bait and Switch

a. Pretext Interview Definition and Example

One of the continuing efforts of the Estate Planning, Trust and Probate Section of the State Bar of California has been its truth squad subcommittee. Its purpose is to investigate and alert the public to the dangers of so-called trust mills that use the popularity of living trusts as a sales device for potentially nefarious purposes. For a number of years, the truth squad has been gathering examples of how some estate-planning businesses use deceptive advertising, scare tactics and attacks on the legal profession to gather clientele and sell often poorly drafted, unnecessary and overpriced estate planning documents to a largely elderly population. Usually, the suspected trust mill has engaged in the unauthorized practice of law; however, in most cases, district attorneys are unable to devote scarce resources to its prosecution. If an attorney is involved, the State Bar has brought disciplinary charges in egregious cases. The attorneys have usually been relatively new admittees who were paid to review trusts drafted by a nonlawyer.

The truth squad was not formed to investigate attorneys specializing in low-cost, high-volume production of estate planning documents where the firm has an attorney-client relationship with the testator. Instead, the squad has been focusing its attention on those organizations that employ unlicensed persons and use high-pressure sales tactics to encourage people to enter into trusts whether or not it is a legally wise method of estate planning. In those cases, documents are generally preprinted forms that may or may not fit the testator's desires, are drafted by nonattorneys and may be reviewed by a mill-employed attorney who never communicates with the client. According to the truth squad, it uncovered one instance where the attorney was reviewing approximately 200 trusts per week at the rate of $ 40 per trust. A related practice employed at some trust mills involves attaching other more lucrative products to the sale of a living trust. For example, sellers of trusts want to convince an elderly person with a modest liquid estate of $100,000 to form a trust. The seller says the trust will prevent the state from taking over a testator's assets at death, having the assets tied up in court for years and having the person's estate open to the public and subject to potential claims of unknown parties. For approximately $1,500, a certified trust specialist (meaning a nonattorney) will create a trust document and protect the elderly person's estate from all the evils of probate. Later, another salesperson will call on the elderly person and tell him that the liquid assets placed in a trust are still not safe since they are in banks that may default. The only solution is to purchase an annuity (from an insurance company for whom the salesperson is an agent). The annuity is backed by billions in assets, says the salesperson, and owned by a top-rated insurer. No one has ever lost a penny owning this company's annuity. In response, the elderly person closes certificate accounts and IRAs and pays the resulting penalties and income taxes. Based on these high-pressure tactics and deceptive claims, the elderly person owns a trust that may not be necessary, may not be drafted properly or may not be fully funded, and has paid substantial sums for an annuity that provides neither additional protection nor income.

In July 1996, the California Attorney General and the California State Bar jointly initiated legal action against Alliance for Mature Americans alleging that sales representatives visited senior citizens in their homes, used scare tactics to close the deal on a living trust, and then passed along confidential information to sell annuities. Alliance for Mature Americans sold more than 10,000 living trust packages and more than $200 million in annuities. The average age of an Alliance client was 73, and some suffered from Alzheimer's and Parkinson's disease. In early 1997 the California Attorney General announced that a settlement was reached with Alliance for Mature Americans. As part of that settlement, Alliance agreed to reimburse its clients $1 million in fees to prepare living trusts, to pay a $100,000 civil penalty to the State of California, and to stop selling and preparing living trusts for individuals. Alliance is basically out of the trust business. A settlement was also entered into by the Fidelity and Guaranty Life Insurance Company (F&G Life) for annuities sold through Alliance for Mature Americans. The settlement provides each California senior who purchased the F&G Life annuity 60 days to decide whether to keep the annuity or to cancel it, thereby receiving a full refund of the purchase price with interest and without penalties. F&G Life will also pay $150,000 to the State Bar of California to be used to educate senior citizens on estate planning matters and to protect them from estate planning abuses.

b. Long-Term Care Sales

Long-term care insurance and annuity sales can be tied together in the senior market. Addressing health care issues (long-term care) and financial issues (annuities) are different sides of the same coin. Seniors can perceive annuities as a funding source of long-term care. Agents should be aware of the ‘bait and switch’ issue arising from long-term care sales. There is a belief that agents will sell insurance to those who need the coverage and those who can afford it without distinguishing between the two. A salesman has a commission incentive to sell a long-term care policy, so their claim that a person must have the coverage may not be accurate and promised benefits may not be exactly as explained. Long-term care insurance premiums are variable and since this type of coverage is relatively new, there is not much to go on as far as experience rating is concerned. Policies are priced largely based on the age at which a policyholder first buys coverage. If policyholders face an unanticipated, major rate increase 10 years later, they have few options to change plans or insurers without paying even higher rates because of their increased ages. The competitive market system encourages insurers to price a product cheaply at the beginning and then raise premiums rapidly as policyholder’s age and file claims. These practices result in forced lapses and sour policyholders, their families and friends on the product itself.

Companies promising lower premiums may be offering them because obscure policy provisions may not be favorable, or it is a bait-and-switch gambit where the premiums will almost certainly be raised. These bait-and-switch tactics entice consumers with prices the providers know will be raised in the future. As estimated payouts change and rates increase, however, companies face no disincentives for their mistaken projections. The public should avoid the companies that have large increases in premiums in the past. Insurance commissioners across the country are being granted the legislative authority to ban the sale of a company’s policies for a several years if it persistently files new policies that have inadequate initial rates and are inherently are ‘bait and switch’ offerings.

Consumers should do their homework and buy a policy only from an established company in excellent financial condition. Financially sound industry leaders are likely to maintain premiums. Such insurers do not want to attract negative attention in the media nor do they want to trigger adverse legislation. Farsighted companies that will be around tomorrow cannot afford to be too aggressive in raising rates, so it's likely that the initial premium will remain fixed. Policyholders may pay a little more initially for the coverage, but they are protected against “rate shock” in later years when their incomes are at best static and likely declining.

c. Unauthorized Practice of Law

Drafting, delivering, and interpreting legal documents <u>for compensation or pay</u> are all forms of practicing law. No person shall practice law in California unless the person is an active member of the State Bar. (Business and Professions Code 6125)

6. Cause for Suspension

Any of the following acts committed by an agent constitutes cause to suspend or revoke his or her insurance license (Section 1668.1 of the CIC).

a. Loans

The licensee has induced a client, whether directly or indirectly, to cosign or make a loan, make an investment, make a gift, including a testamentary gift, or provide any future benefit through a right of survivorship to the licensee, or to any of the persons who hold a relationship to the licensee as listed below.

b. Agent Beneficiaries, Trustee, and Power of Attorney

The licensee has induced a client, whether directly or indirectly, to make the licensee or any related person a beneficiary under the terms of any intervivos or testamentary trust or the owner or beneficiary of a life insurance policy or an annuity policy.
The licensee has induced a client, whether directly or indirectly, to make the licensee, or a person who is registered as a domestic partner of the licensee, or is related to the licensee by birth, marriage, or adoption, a trustee under the terms of any intervivos or testamentary trust. However, if the licensee is also licensed as an attorney in any state, the licensee may be made a trustee under the terms of any intervivos or testamentary trust, provided that the licensee is not a seller of insurance to the trustor of the trust.
The licensee, who has a power of attorney for a client has sold to the client or has used the power of attorney to purchase an insurance product on behalf of the client for which the licensee has received a commission.

c. Benefits Payable to Family of Friends of Agent

Causing benefits to be paid to or made payable is not acceptable. This includes inducing a client to provide benefits to anyone related to the agent, a friend or business acquaintance; or the agent's domestic partner

Related parties- This refers to-
A person who is related to the licensee by birth, marriage, or adoption.
A person who is a friend or business acquaintance of the licensee.
A person who is registered as a domestic partner of the licensee.

Exceptions- This section does not apply to situations in which the <u>client</u> is a person related to the licensee by birth, marriage, or adoption or who is registered as a domestic partner of the licensee. (SB 618 and Section 1668.1 of the CIC)

7. Penalties

Here is a listing of penalties for insurance licensees in California who want to violate or circumvent proper sales practices. Refer to Attachment III for additional information.

An insurer or agent must not misrepresent the terms of a policy issued by the insurer or promised to be issued, the benefits or privileges agreed to in the policy, or the future dividends payable under the policy. Insurers or their representatives shall not make any misrepresentation as an inducement to purchase a policy. Agents must not use falsehood or misrepresentation to persuade a policyholder to lapse, forfeit or surrender his or her insurance. Conversely, insurers and their agents may not use any representation or comparison of insurers or policies to an insured which is misleading, for the purpose of inducing or tending to induce him to lapse, forfeit, change or surrender his insurance, whether on a temporary or permanent plan.

Any person violating the provisions of Sections 780 or 781 of the California Insurance Code is subject to a fine up to $25,000, or in a case in which the loss of the victim exceeds $10,000, by fine up to three times the amount of the loss suffered by the victim, by imprisonment up to one year in a county jail, or a combination of fine and jail time. Restitution to the victim ordered pursuant to Section 1202.4 of the Penal Code gets satisfied before any fine is collected. (Section 780, 781, 782 of the CIC)

Persons engaged in transactions of insurance, other than an insurer, who violate the rules regarding sales practices for agents are liable for an administrative penalty-
For the first violation, it is no less than one thousand dollars ($1,000).
A second or subsequent time an agent commits a knowing violation of this article, he or she is liable for an administrative penalty of no less than five thousand dollars ($5,000) and no more than fifty thousand dollars ($50,000) for each violation.

If an action is brought against a licensee as in the previous paragraph and it is determined that the licensee may reasonably be expected to cause significant harm to seniors, the commissioner may suspend his or her license pending the outcome of a hearing made available to the licensee.

Insurers who violate this articles relating to sales practices are liable for an administrative penalty as follows-
Ten thousand dollars ($10,000) for the first violation.
Insurers who violate this article with a frequency as to indicate a general business practice or commits a knowing violation of this article, is liable for an administrative penalty of no less than thirty thousand dollars ($30,000) and no more than three hundred thousand dollars ($300,000) for each violation.

The commissioner may require rescission of any contract found to have been marketed, offered, or issued in violation of Insurance Code articles pertaining to good sales practices. (Sections 789.3, 10509.9 of the CIC)

A proceeding that involves allegations of misconduct committed against a person age 65 or over shall be held within 90 days after receipt by the department of the notice of defense, unless the department or the administrative law judge grants a continuance of the hearing. Under certain circumstances, a continuance of the hearing may be granted. After a duly conducted hearing, the commissioner may suspend or revoke the license of any person or entity that is found in violation of the pertinent articles. (Sections 1738.5, 10509.9 of the CIC)

E. The Importance of Determining Client Suitability for Annuity Sales

NAIC Senior Protection in Annuity Transactions Model Act- During its 2003 fall national meeting, the National Association of Insurance Commissioners (NAIC) adopted a model regulation designed to help protect senior consumers when they purchase or exchange annuity products. The new measure is designed to ensure that the insurance needs and financial objectives of senior consumers (age 65 or older) are appropriately addressed. The Act is intended to provide senior consumers peace of mind that they are well protected when making financial decisions, according to an NAIC press release. The new regulation sets forth standards and procedures for insurers and insurance producers relating to the purchase or exchange of annuity products involving senior consumers as follows:

In recommending to a senior consumer the purchase of an annuity or exchange of an annuity that results in another insurance transaction, the insurance producer, or the insurer where no producer is involved, must have reasonable grounds for believing that the recommendation is suitable for the senior consumer on the basis of the facts disclosed by the senior consumer as to his or her investments and other insurance products and as to his or her financial situation and needs.

Prior to the purchase or exchange of an annuity based on a recommendation, there must be reasonable efforts to obtain information about the senior consumer's financial status, tax status, investment objectives, and other information that could be reasonably considered by the insurance producer or insurer in making recommendations to the senior consumer.

Neither an insurance producer, or an insurer where no producer is involved, will have any obligation to a senior consumer related to any annuity transaction if a consumer refuses to provide relevant information requested by the insurer or insurance producer, decides to enter into an insurance transaction that is not based on a recommendation of the insurer or insurance producer, or fails to provide complete or accurate information.

An insurer or insurance producer's recommendation will be considered reasonable under the circumstances actually known to the insurer or producer at the time of the recommendation.

An insurer must assure that a system to supervise recommendations is in place that is reasonably designed to achieve compliance with the regulation. An insurer may meet its obligations by conducting periodic reviews or by contracting with a third party, such as an independent agency, to maintain the supervisory system and to provide certification to the insurer that the supervision is occurring.

Compliance with the National Association of Securities Dealers Conduct Rules regarding suitability will satisfy the requirements for variable annuities. However, this does not limit the insurance commissioner's ability to enforce the provisions of the new regulation.

Additionally, the model regulation does exempt insurers and insurance producers from recommendations involving direct-response solicitations (where no recommendations are made based on information provided by the consumer pursuant to the regulation), as well as various funded contracts covered under federal law.

1. Identify the Need for Information Prior to Making Recommendations

It is the duty of agents to reminded potential purchasers that annuities are not suitable for all investors, particularly those who may need cash for short term needs. This is especially true with variable annuities, whose hybridization of both securities and insurance features may be more difficult to understand.

In the largest disciplinary complaint ever filed up to that time by the National Association of Securities Dealers (NASD), it was reported on January 15, 2004 that the agency had charged securities broker/dealer Waddell and Reed of Overland Park, Kansas with “selling unsuitable investments to thousands of clients.” The press release indicated that the “firm advised 6,700 clients to switch their variable annuities from one insurer to another in transactions that generated millions of dollars in fees for the firm but did not benefit the clients. Roughly 20% of the exchanges were likely to result in the clients’ losing money, according to the NASD.” Supervisory and suitability charges were also leveled against the firm and two senior executives. Along with the disciplinary announcement mentioned above, the Securities and Exchange Commission and the NASD advise public investors to ask questions before buying variable annuities and life insurance products.

a. Age of the Consumer

An issue directly affecting the annuity decision is the age of the consumer. It is a primary factor in determining suitability. Insurers offer different types of annuities based on the circumstances of the consumer. Annuities’ payout rates are calculated using the average life expectancy, of which a primary consideration is the current age of the consumer (see the actuarial table elsewhere in this book).

Once age and actuarial payout are determined and made clear to a potential annuity purchaser, there is a need to assess the consumer’s appetite and capacity for loss, as well as their desire for gain. There are a range of factors to be considered, amongst which it is always important to put any answers in the context of the age of the consumer and their capacity to repair losses. One further factor is to assess both the consumers need for capital security, set against their need for a return on the investment, particularly where income or later access to capital may be required. Involvement is an important psychological construct for understanding consumers’ underlying purchase decision process and those factors that shape product perceptions.

b. Financial Status of the Consumer

Issues should be addressed by seniors (or on their behalf) before purchasing an annuity. Among the considerations are the following;
i. Income- Passive (investments/retirement) and earned (from working). Some seniors want to keep working; others have to because they did not or could not invest.
ii. Liquid assets- Assets that can be converted into cash quickly and with minimal impact to the price received, they are generally regarded in the same light as cash
iii. Presence of long-term care (LTC) insurance- Long-term care insurance covers custodial care generally not covered by health insurance, Medicare, or Medi-Cal.

Potential purchasers should be asking such questions as;
Might I need this money in the short term?
Do I have enough money now to purchase this product?
What am I paying for each feature?
Are the extra fees worth it for me?

Will I have to take out a home loan to keep up with payments?

Insurance agents recommending annuities to a client age 65 or older must have reasonable grounds for believing that the annuity is appropriate for the consumer. This is after the representative obtains the necessary client financial information when determining annuity suitability. The rules also say that producers do not have obligations to the client if the senior refuses to provide pertinent information or decides to enter into an insurance transaction that was not recommended by the producer.

Insurers must design compliance standards to ensure that senior clients are getting appropriate advice and that producers are following the rules. Companies are charged with the responsibility to make sure that their agents or producers are getting the right information to serve the consumer well. Insurers have a responsibility to set up guidelines and education and to monitor their insurance producers. It is the responsibility of the agent to verify that all compliance issues, all financial suitability forms promulgated by the insurer for a particular policy or class of policies are presented to the prospective annuity purchaser.

Regulatory turf issues are not ruled out. A spokesperson for the American Council of Life Insurers said that with variable annuities included in the NAIC proposal, there is a potential conflict of the supervisory duties of broker-dealers under the NASD rules. The Senior Protection Annuity Model Act provisions say the supervisory role rests with the insurance company. The NASD requires that broker-dealers supervise its reps that sell insurance with already-created compliance rules. It is not clear how the two sets of rules would mesh. Nonetheless, the licensee must satisfy the California Insurance Code and pronouncements of the Department of Insurance.

c. Tax Status of the Consumer

A primary concern for consumers is determining how much income tax will be owed on payments from the annuity contract. The tax treatment of a distribution depends on if it is received before or after the annuity starting date, and on the amount of the investment. Cash withdrawals from deferred or retirement annuities before age 59½ are generally subject to a 10% penalty tax on the portion included in gross income. Payments received on or after the annuity starting date are treated differently.

The General Rule- This is a calculation method prescribed by the IRS. Under the General Rule, an individual determines the tax-free part of each annuity payment based on the ratio of the cost of the contract to the total expected return. Expected return is the total amount the taxpayer and other eligible annuitants can expect to receive under the contract. To figure it, a person must use life expectancy (actuarial) tables prescribed by the IRS. The General Rule must be used if a person receives pension or annuity payments from:
1) A nonqualified plan (such as a private annuity, a purchased commercial annuity, or a nonqualified employee plan), or
2) A qualified plan if the person is age 75 or older on the annuity starting date and his or her annuity payments are guaranteed for at least 5 years.

d. Investment Objectives of the Consumer

It is generally considered that the first step in establishing financial goals is to analyze

the current financial condition. This can be easily accomplished by examining assets and establishing a budget. Budgeting should also include cash reserves for emergencies and insurance coverage. Once the current financial condition has been evaluated, the second step is to establish broad investment objectives. There are essentially three primary investment goals:
Preservation of principal.
Generation of stable after-tax income.
Appreciation of principal.

Investment Objectives- Like so many aspects of life, terms of art can sometimes hinder effective communication. In one allegorical case, the broker testified that he asked his client what his investment objectives were and the client replied, "To Make Money!" This cavalier response sent a message that the client was willing to take big risks in order to get big gains. The broker noted "speculation" as the client's investment objective, yet the client testified that what he meant was that he wanted his money to grow, but not at the expense of his principal.
"Investment objective" is what is known as a term of art in the securities industry. It does not mean that an investor knows what specific investments he or she wants to make. Nor does it require some abstract or philosophical response. Standard choices when considering investment objectives are:
Preservation of Principal- The investor does not want to lose any of the money being invested. Such people are generally more comfortable with conservative, stable investments and are not willing to take any risk of principal (the only risk one might be willing to assume is the amount and certainty of the income or appreciation).
Stable Income- The investor wants to generate income from the money being invested and is willing to take some small risk in order to receive increased income.
Appreciation of Principal- The investor has more of a long-term investment horizon. He or she may be saving for a future goal and is willing to take some risk (approximately 10% of portfolio is a common rule of thumb) in order to increase the growth potential. Or it could be that diversification to achieve a combination of both income and some capital appreciation is desired. Such individuals are comfortable with moderate risk.
Other investment categories include-
Aggressive Growth – Investing in order to maximize returns.
Speculation - The investor is willing to lose all or a substantial portion of the money.

The Dilemma
Most customer disputes center on the issue of what were the client's investment objectives. Setting investment objectives can be difficult for several reasons. First, the great majority of investors don't have a clear understanding of what they want to do. And for those who do, they do not clearly express it. Second, insurers or brokerage firms usually only require a few pre-printed boxes of investment objectives (such as those above) be shown on the new account form. These categories may prove to be either too limiting or too susceptible to interpretation. Look at the issue from another perspective; the agent checks all of the boxes for the client's investment objectives, reasoning that the client said he or she wanted to do a little of everything. This defeats the purpose of the information – There is no yardstick or guide to ensure that suitable investments are being made? Arguably, everything is suitable and the agent has carte blanche to recommend anything and everything under the sun to the client.
Individuals must make sure that investment objectives reflect the overall guideline for how he or she wants the investments handled.

e. Other Information to be Used or Considered Relevant

Prior to the execution of a purchase or exchange of an annuity resulting from a recommendation, an insurance producer, or an insurer where no producer is involved, are to make reasonable efforts to obtain information concerning such other information used or considered to be reasonable by the insurance producer, or the insurer where no producer is involved, in making recommendations to the senior consumer.

Agents should assist in determining suitability for annuity sales by asking a series of questions, an example of which follows. This should be in printed form, signed or acknowledged by the senior, so that both parties know an effort was made to get everything down in writing.
Age
Tax bracket
Upcoming financial needs (does the senior anticipate withdrawing one third or more of his or her total cash and investments for a major purchase, college tuition, or other major need?)
The need for income, whether adequate funds for emergency financial needs are available.
Expected future earnings from employment
What percentage of monthly income is used to pay installment debts (credit cards, auto loans, etc.)?
What percentage of total income does current investment make?
The ability and willingness to take risk
The individual’s investment knowledge and prior investing experience

Clear and concise information is essential to clearly spelling out investment objectives.

2. Required Record Keeping

Documenting the client files involves keeping track of the actions taken in dealing with the policy owner. A properly documented file should contain complete and accurate answers to all pertinent questions. This allows the agent to properly assess the need for insurance and substantiates the reason for the sale. Effective case notes should also be kept in the policy owner's file. These should list the date and time of contact with the policy owner and concise summaries of all interactions. It is also recommended that the agent document the level of service provided to the policy owner.

Good record keeping also applies to administrators and those who collect charges or premiums for annuities. Companies must maintain adequate books and records of all transactions between insurers and insured for five years after the contract period ends. The insurer and the Insurance Commissioner have access to the records. Information in the books and records is confidential, but can be used by the Commissioner in any proceedings instituted against the administrator. Failure to keep or maintain records as required equates to grounds for the suspension or revocation of the certificate of registration of the administrator (Section 1759.3 of the CIC)

At the time of sale of an annuity the agent must do all of the following:

- Make a record of any recommendation subject suitability requirements of Section 10509.914(a) of the CIC
- If applicable, obtain a customer-signed statement documenting the customer's

refusal to provide suitability information.
- Get a signed statement from the consumer acknowledging that an annuity transaction is not recommended if the customer decides to buy an annuity contrary to the agent's recommendation.

(Section 10509.914(e) of the CIC)

F. Identify Required Disclosures

Please refer to Attachment II for more information.

1. Discuss the Need for Full Contract Disclosure

The objective of the mandate for full disclosure is to provide a certain minimum of information about annuity contracts so as to protect consumers and foster consumer understanding of the contract. Important in this regard are cash surrender benefits, money paid to the policyholder if the policy terminates before maturity. Contracts not providing cash surrender benefits or death benefits at least equal to the minimum nonforfeiture amount before the annuity phase starts must prominently state this fact in the contract (Section 10168.7 of the CIC).

Contract information should meet qualitative objectives of adequate disclosure. The goal of disclosure is to ensure that purchasers of annuities understand certain basic features of annuity contracts. Adequate disclosure relates particularly to objectives of relevance, neutrality, completeness, and understandability. Information should be presented in a way that facilitates understanding and avoids erroneous implications. Contract headings, captions, and amounts should be supplemented by enough additional information so that their meaning is clear but not by so much information that important matters are buried in a mass of trivia.

G. Policy Cancellations and Refunds

Purchasers of new policies should be sure to read the new policy carefully. As with any contract, they should be encouraged to ask the agent or company for an explanation of anything not understood.

1. Free Look

A 30-day free look period is required for insurance products sold to individuals 60 years of age or over in California for the purpose of review of the contract. Return during this “free look” period voids the policy, with premiums fully refundable. Consumers should use the time to make sure the policy offers the expected benefits. The policy should be checked for accuracy and for policy limitations, exclusions, or waiting periods. One of the duties of the insurance producer, the individual interfacing with a prospective insured, to see that the consumer understands the 30-day free look period (Section 10127.9 of the CIC).

Every policy of individual life insurance and every individual annuity contract delivered or issued to a senior citizen in California on and after July 1, 2004, are to have printed on (or attached to it) a notice stating that, after receipt of the policy by the owner, the policy may be returned by the owner for cancellation by delivering it or mailing it to the insurer or agent from whom it was purchased. The period of time allowed for return of the policy by the insured must be clearly stated on the notice and this period cannot be less than 30 days. The insured may return the policy to the insurer by mail or otherwise at any time during the period specified in the notice. During the 30-day cancellation period, the premium for a variable annuity may be invested only in fixed-income investments and money-market funds, unless the investor specifically directs that the premium be invested in the mutual funds underlying the variable annuity contract. Return of the policy within the 30-day cancellation period has one of the following effects:

1.) In the case of individual life insurance policies and variable annuity contracts for which the owner has not directed that the premium be invested in the mutual funds underlying the contract during the cancellation period, return of the policy during the cancellation period shall have the effect of voiding the policy from the beginning, and the parties shall be in the same position as if no policy had been issued. All premiums paid and any policy fee paid for the policy shall be refunded by the insurer to the owner within 30 days from the date that the insurer is notified that the owner has canceled the policy. The premium and policy fee shall be refunded by the insurer to the owner within 30 days from the date that the insurer is notified that the owner has canceled the policy.
2.) In the case of a variable annuity for which the owner has directed that the premium be invested in the mutual funds underlying the contract during the 30-day cancellation period, cancellation shall entitle the owner to a refund of the account value. The account value shall be refunded by the insurer to the owner within 30 days from the date that the insurer is notified that the owner has canceled the contract.

For individual annuity policies issued or delivered to senior citizens in this state on or after January 1, 2004. All policies subject to this section (effective January 1, 2003) are construed to be in compliance with this section, and any provision in any policy which is in conflict with this section is of no force or effect.

Every individual life insurance policy and every individual annuity contract, other than variable contracts and modified guaranteed contracts, subject to this section, that is delivered California shall have the following notice either printed on the cover page or policy jacket in **12-point bold print** with one inch of space on all sides or printed on a sticker that is affixed to the cover page or policy jacket:

"IMPORTANT

YOU HAVE PURCHASED A LIFE INSURANCE POLICY OR ANNUITY CONTRACT. CAREFULLY REVIEW IT FOR LIMITATIONS.

THIS POLICY MAY BE RETURNED WITHIN 30 DAYS FROM THE DATE YOU RECEIVED IT FOR A FULL REFUND BY RETURNING IT TO THE INSURANCE COMPANY OR AGENT WHO SOLD YOU THIS POLICY. AFTER 30 DAYS, CANCELLATION MAY RESULT IN A SUBSTANTIAL PENALTY, KNOWN AS A SURRENDER CHARGE."

The phrase "after 30 days, cancellation may result in a substantial penalty, known as a surrender charge" may be deleted if the policy does not contain those charges or penalties.

Every individual variable annuity contract, variable life insurance contract, or modified guaranteed contract subject to this section, that is delivered or issued for delivery in this state, shall have the following notice either printed on the cover page or policy jacket in **12-point bold print** with one inch of space on all sides or printed on a sticker that is affixed to the cover page or policy jacket:

IMPORTANT

YOU HAVE PURCHASED A VARIABLE ANNUITY CONTRACT (VARIABLE LIFE INSURANCE CONTRACT, OR MODIFIED GUARANTEED CONTRACT). CAREFULLY REVIEW IT FOR LIMITATIONS.

THIS POLICY MAY BE RETURNED WITHIN 30 DAYS FROM THE DATE YOU RECEIVED IT. DURING THAT 30-DAY PERIOD, YOUR MONEY WILL BE PLACED IN A FIXED ACCOUNT OR MONEY-MARKET FUND, UNLESS YOU DIRECT THAT THE PREMIUM BE INVESTED IN A STOCK OR BOND PORTFOLIO UNDERLYING THE CONTRACT DURING THE 30-DAY PERIOD. IF YOU DO NOT DIRECT THAT THE PREMIUM BE INVESTED IN A STOCK OR BOND PORTFOLIO, AND IF YOU RETURN THE POLICY WITHIN THE 30-DAY PERIOD, YOU WILL BE ENTITLED TO A REFUND OF THE PREMIUM AND POLICY FEES. IF YOU DIRECT THAT THE PREMIUM BE INVESTED IN A STOCK OR BOND PORTFOLIO DURING THE 30-DAY PERIOD, AND IF YOU RETURN THE POLICY DURING THAT PERIOD, YOU WILL BE ENTITLED TO A REFUND OF THE POLICY'S ACCOUNT VALUE ON THE DAY THE POLICY IS RECEIVED BY THE INSURANCE COMPANY OR AGENT WHO SOLD YOU THIS POLICY, WHICH COULD BE LESS THAN THE PREMIUM YOU PAID FOR THE POLICY. A RETURN OF THE POLICY AFTER 30 DAYS MAY RESULT IN A SUBSTANTIAL PENALTY, KNOWN AS A SURRENDER CHARGE."

The words "known as a surrender charge" may be deleted if the contract does not contain those charges.

This requirement does not apply to life insurance policies issued in connection with a credit transaction or issued under a contractual policy-change or conversion privilege provision contained in a policy. Additionally, this requirement does not apply to contributory and noncontributory employer group life insurance, contributory and noncontributory employer group annuity contracts, and group term life insurance, unless the following exception applies;

When an insurer, its agent, group master policyowner, or association collects more than one month's premium from a senior citizen at the time of application or at the time of delivery of a group term life insurance policy or certificate, the insurer must provide the senior citizen a prorated refund of the premium if the senior citizen delivers a cancellation request to the insurer during the first 30 days of the policy period.

For purposes of this discussion a senior citizen means an individual who is 60 years of age or older on the date of purchase of the policy. (Section 10127.10 of the CIC)

Every life insurer that uses an agent in a life insurance or annuity sale must require as a part of each completed application for life insurance or annuity, a statement signed by the agent as to whether he or she knows replacement is or may be involved in the transaction. Where a replacement is involved, the insurer must require from the agent with the application for life insurance or annuity:

1.) A list of all of the applicant's existing life insurance or annuity to be replaced, and a copy of the replacement notice provided the applicant pursuant to Section 10509.4 of the Insurance Code. The existing life insurance or annuity shall be identified by name of insurer, insured, and contract number. If the existing insurer has not assigned a number, an alternative identification, such as an application or receipt number shall be listed.
2.) Send to each existing life insurer a written communication advising of the replacement or proposed replacement and the identification information obtained pursuant to this section and a policy summary, contract summary, or ledger statement containing policy data on the proposed life insurance or annuity.

Cost indices and equivalent level annual dividend figures need not be included in the policy summary or ledger statement. This written communication is to be made within three working days of the date the application is received in the replacing insurer's home or regional office, or the date the proposed policy or contract is issued, whichever is sooner.

Every existing life insurer or the insurer's agent that undertakes a conservation shall, within 20 days from the date that the written communication are received by the existing insurer, furnish the policyowner with a policy summary for the existing life insurance or ledger statement containing policy data on the existing policy or annuity. Information relating to premiums, cash values, death benefits, and dividends, if any, shall be computed from the current policy year of the existing life insurance. The policy summary or ledger statement shall include the amount of any outstanding indebtedness, the sum of any dividend accumulations or additions, and may include any other information that is not in violation of any regulation or statute. Cost indices and equivalent level annual dividend figures need not be included. When annuities are involved, the disclosure information shall be that in the contract summary. The replacing insurer may request the existing insurer to furnish it with a copy of the summaries or ledger statement, which shall be within five working days of the receipt of the request.

The replacing insurer shall maintain evidence of the "notice regarding replacement," the policy summary, the contract summary, and any ledger statements used, and a replacement register, cross-indexed by replacing agent and existing insurer to be replaced. The existing insurer shall maintain evidence of policy summaries, contract summaries, or ledger statements used in any conservation. Evidence that all requirements were met is to be maintained for at least three years. The replacing insurer must also provide in its policy or in a separate written notice which is delivered with the policy that the applicant has a right to an unconditional refund of all premiums paid which right may be exercised within a period of 30 days commencing from the date of delivery of the policy. In the case of variable annuity contracts, variable life insurance contracts, and modified guaranteed contracts, return of the contract during the cancellation period entitles the owner to a refund of account value and any policy fee paid for the policy. The insurer is to refund the account value and policy fee to the owner within 30 days from the date that the insurer is notified that the owner has canceled the policy. (Section 10509.6 of the CIC)

All disability insurance and life insurance policies and certificates offered for sale to

individuals age 65 or older in California must provide an examination period of 30 days after the receipt of the policy or certificate for purposes of review of the contract, at which time the applicant may return the contract. The return voids the policy or certificate from the beginning, and the parties wind up in the same position as if no contract had been issued. All premiums paid and any policy or membership fee is fully refunded to the applicant by the insurer or entity in a timely manner. For the purposes of this section a timely manner means no later than 30 days after the insurer or entity issuing the policy or certificate receives the returned policy or certificate. If the insurer or entity issuing the policy or certificate fails to refund all of the premiums paid, in a timely manner, then the applicant receives interest on the paid premium at the legal rate of interest on judgments as statutorily provided. The interest is paid from the date the insurer or entity received the returned policy or certificate. Each policy or certificate must have a notice prominently printed in no less than 10-POINT UPPERCASE TYPE, on the cover page of the policy or certificate and the outline of coverage, stating that the applicant has the right to return the policy or certificate within 30 days after its receipt via regular mail, and to have the full premium refunded.
Conflict- If there is a conflict between the free-look procedures just outlined and those found in Section 10127.10 of the California Insurance Code, the provisions of Section 10127.10 (found in III C & D, IV C of this book) prevail. (Section 786 of the CIC)

2. Free Look for Persons Younger than 60 Years Old

Policies delivered after January 1, 1990, are to have printed or attached a notice stating that the policy may be returned by the owner for cancellation by delivering or mailing it to the insurer or to the agent. The return time is to be clearly stated on the notice and cannot be less than 10 days nor more than 30 days. Return during the cancellation period voids the policy from the beginning, and the parties end up in the same position as if no policy had been issued. All premiums and any policy fee paid are to be refunded within 30 days of the date of cancellation. In the case of variable annuity contracts, variable life insurance contracts, and modified guaranteed contracts, return of the contract during the cancellation period entitles the owner to a refund of account value and any policy fee paid for the policy. This section applies to all policies after January 1, 1990, but does not apply to any policy subject to Section 10127.7 (policies with face value less than $10,000) (Section 10127.9 of the CIC).

X. SB 483, Kuehl

Legislative Counsel's Digest

An important indicator of general legislative intent is the *Legislative Counsel's Digest.* It is a summary of the bill prepared by the nonpartisan Legislative Counsel's Office that tells the legislators what they are voting on. Here is the summary for SB 483, Kuehl, Medi-Cal: Home and Facility Care;

> Existing law provides for the Medi-Cal program, which is administered by the State Department of Health Care Services, and which provides health care services to qualified low-income recipients. Existing law establishes various criteria for eligibility for Medi-Cal benefits. The Medi-Cal program is partially governed and funded by federal Medicaid provisions. Under existing law, Medi-Cal benefits include nursing facility services and home-and community-based services.
>
> This bill would, to the extent required by federal law, require any applicant for, or recipient of, Medi-Cal benefits who requests medical assistance for home and facility care, as defined, to meet the specific eligibility requirements for the receipt of medical assistance for home and facility care set forth in these provisions.
>
> The bill would require an individual, as a condition of eligibility for medical assistance for home and facility care, to disclose a description of any interest that the individual or his or her spouse has in an annuity, as specified. The bill would also require the state, as an operation of law, to become a remainder beneficiary of certain annuities, as described, unless the individual notifies the state in writing that he or she prohibits the state from becoming a remainder beneficiary, as provided, and would require the department to inform an individual and his or her spouse of this fact at the time of the individual's application or redetermination of Medi-Cal eligibility. The bill would also require that before any penalties, as provided for in the bill, are imposed that may result in a period of ineligibility for medical assistance for home and facility care, an individual shall have the right to demonstrate that a period of ineligibility would be an undue hardship, as defined. It would require the state to provide notice to individuals requesting medical assistance for home and facility care of the undue hardship exception and would require a determination of whether an undue hardship exists to be made before an applicant is denied eligibility for medical assistance for home and facility care. If an individual or his or her spouse notifies the state in writing that he or she prohibits the state from becoming a remainder beneficiary to his or her annuity, the bill would require the annuity to be treated as a transfer of assets for less than fair market value for purposes of determining Medi-Cal eligibility.
>
> This bill would express the intent of the Legislature that its provisions shall apply prospectively to any individual to whom the bill applies commencing from the date regulations adopted pursuant to this bill are filed with the Secretary of State.

A. Home Equity Limits

The federal Deficit Reduction Act of 2005 (DRA) provided that individuals who have home equity in excess of $500,000 are disqualified from Medicaid eligibility for nursing facility services and other long-term care services. Medi-Cal is the state's version of the federal Medicaid program. However, the DRA allows states to adopt statutes to raise the home equity cap to $750,000 for the purposes of eligibility for Medi-Cal nursing facility and long-term care services. This bill adopts the federal option to raise the home equity cap to $750,000 so that individuals with home equity equal to or less than this amount may qualify for long-term care services under Medi-Cal.

An "equity interest" means the lesser of the following:

- The assessed value of the principal residence determined under the most recent tax assessment, less any encumbrances of record.
- The appraised value of the principal residence determined by a qualified real estate appraiser who has been retained by the applicant or beneficiary, less any encumbrances of record.

This section does not apply to an individual if any of the following circumstances exist:

- The spouse of the individual or the individual's child, who is under 21 years of age, or who is blind or who is disabled.
- The individual was determined eligible for medical assistance for home and facility care based on an application filed before January 1, 2006.
- The department determines that ineligibility for medical assistance for home and facility care would result in demonstrated hardship on the individual. (Sec. 14006.15(c) of the Welfare and Institutions Code)

B. Establishment of Hardship Exception

Consideration is to be given as to whether an undue hardship, as described below exists prior to finding that an applicant subject to a period of ineligibility for medical assistance for home and facility care. No person is to be subject to a period of ineligibility for medical assistance for home and facility care at the time of the initial application or redetermination if the department determines that an undue hardship exists. An undue hardship exists under any of the following circumstances:

- The individual has been determined eligible for medical assistance for home and facility care based on an application filed on or after January 1, 2006, and before the date that regulations adopted pursuant to this section.
- The deprivation of medical assistance for home and facility care would cause an endangerment to the life or health of the individual.
- The denial of medical assistance for home and facility care would result in the eviction of the individual from a nursing home.
- The individual is otherwise eligible for the Medi-Cal program and unable to obtain home and facility care without Medi-Cal.
- The denial of medical assistance for home and facility care would cause the individual to be unable to remain at home or in the community and would hasten or cause the individual's entry into a medical or long-term care institution.
- The individual would be deprived of food, clothing, shelter, or other necessities of life.

In accordance with the Social Security Act any of the following may request a fair hearing on the issue of undue hardship:

- An individual requesting or receiving medical assistance for home and facility care.
- A personal representative of an individual requesting or receiving medical assistance for home and facility care.
- The facility in which the individual requesting or receiving medical assistance for home and facility care is residing, with the consent of that individual or the personal representative of that individual. (Sec. 14015.1 and 14015.2 of the Welfare and Institutions Code)

C. Look-back Period

It is to be presumed that assets transferred by the applicant or beneficiary prior to the look-back period established by the department preceding the date of initial application were not transferred to establish eligibility or reduce the share of cost. These assets are not considered in determining eligibility. (Sec. 14015(c) of the Welfare and Institutions Code)

D. Establishment of Requirements Related to Annuities, Remainder Beneficiaries.

For the purposes of the discussion of Medi-Cal and home and facility care, the term "equity interest" means the lesser of the following:

- The assessed value of the principal residence determined under the most recent tax assessment, less any encumbrances of record.

The appraised value of the principal residence determined by a qualified real estate appraiser who has been retained by the applicant or beneficiary, less any encumbrances of record. (Sec. 14006.15(a)(2) of the Welfare and Institutions Code)

To be eligible for medical assistance for home and facility care, at the time of application or redetermination the individual must be disclose any interest that he or she or his or her spouse has in an annuity, which is known to the individual or his or her spouse, regardless of whether the annuity is irrevocable or is treated as income or as a resource. Also, at the time of the individual's application or redetermination, the State Department of Health Services will inform the individual and his or her spouse that, by virtue of its provision of medical assistance for home and facility care to the individual, the state will, by operation of law, become a remainder beneficiary of certain annuities, as described below. (Sec. 14006.41(a) and (b) of the Welfare and Institutions Code)

Operation of Law

The phrase "**by operation of law**" is a legal term in which the determination of rights and obligations is made through the automatic effects of the law and not by any private agreement or direct act of the party affected. A right or liability has been created for a party, irrespective of the intent of that party, because it is dictated by existing legal principles. For example, if a person dies without a will, his are determined by operation of law. Events that occur by operation of law do so because courts have determined over time that the rights thus created or transferred represent what the intent of the party would have been, had they thought about the situation in advance; or because the results fulfilled the settled expectations of parties with respect to their property; or because legal instruments of title provide for these transfers to occur automatically on certain named contingencies. Rights that arise by operation of law often arise by design of certain contingencies set forth in a legal instrument. So it is with an individual's application for home and facility care; the legal instruments convey the California's right to become a remainder beneficiary of an annuity.

California's Role as a Remainder Beneficiary

By providing medical assistance for home and facility care to an individual, the state becomes a remainder beneficiary, to the extent required by Section 1917(e) of the federal Social Security Act (42 U.S.C. Sec. 1396p(e)), of annuities purchased in whole or in part by the individual or his or her spouse in which one of them is an annuitant, except as provided in the discussion of Community Spouse Resource Allocation (CSRA), Section 14009.7 of the Welfare and Institutions Code.

These regulations concerning the State of California as remainder beneficiary only apply to those annuities purchased on or after February 8, 2006. Annuities purchased before February 8, 2006, and subjected to a transaction that occurred on or after February 8, 2006 are also included. In this context, "transaction" includes, but is not limited to, any action taken by the individual or his or her spouse that changes the course of payments to be made by the annuity or the treatment of the income or principal of the annuity. The term "transaction" does not mean:

- Routine changes and automatic events that do not require any action or decision on or after February 8, 2006.
- Changes that occur based on the terms of the annuity that existed prior to February 8, 2006, and that do not require a decision, election, or action to take effect.
- Changes that are beyond the control of the individual or the individual's spouse.

An annuity provision that has the effect of restricting the right of the state to become a remainder beneficiary is void.

The state becomes a remainder beneficiary (as described above) unless the individual notifies the state in writing that he or she prohibits the state from becoming a remainder beneficiary, as provided, and would require the department to inform an individual and his or her spouse of this fact at the time of the individual's application or redetermination of Medi-Cal eligibility.

If an individual or his or her spouse notifies the department in writing that he or she prohibits the state from acquiring a remainder interest in his or her annuity, the purchase of the annuity is treated as the transfer of an asset for less than fair market value subject to the mechanisms of Section 14015 of the Welfare and Institutions Code, referred to as "the transfer of assets rule." The rule created a rebuttable presumption that any transfer of assets by medically needy applicants for less than adequate consideration within a given time period prior to their applying for benefits was made with the intent to qualify for assistance.

The Department of Health Services (DHS) notifies the issuer of the annuity of the state's acquisition of its remainder beneficiary interest when the state becomes aware of an annuity in which it has acquired a remainder interest. Upon notification by the Department, the annuity issuer immediately informs the DHS of the amount of income and principal being withdrawn from the annuity as of the date of disclosure.

Upon request by the DHS or its agent, the issuer of the annuity immediately discloses the amount of income and principal being withdrawn from the annuity. The issuer of the annuity immediately notifies the department if there is any change in either of the following:

- The amount of income or principal being withdrawn from that annuity.
- The named beneficiaries of the annuity.

Money received by the state from annuity issuers is deposited into the General Fund. The entirety of the remainder beneficiaries' exercise is implemented pursuant to the requirements of Title XIX of the federal Social Security Act (42 U.S.C. Sec. 1396 et seq.) and any regulations adopted pursuant to that act, and only to the extent that federal financial participation is available (Sec. 14009.6 of the Welfare and Institutions Code).

Exception
The following applies if an annuity is considered part or all of the community spouse resource allowance allowed (exempt resources under Title XIX of the federal Social Security Act),

The state becomes a remainder beneficiary of that portion of the annuity that is not a part of the community spouse resource allowance. The state does not become a remainder beneficiary of an annuity that is any of the following:

- Purchased by a community spouse with resources of the community spouse during the continuous period in which the individual is receiving medical assistance for home and facility care and after the month in which the individual is determined eligible for these benefits.
- Contained in a retirement plan qualified under Title 26 of the United States Code, established by an employer or an individual, including, but not limited to, an Individual Retirement Annuity or Account (IRA), Roth IRA, or Keogh fund.
- An annuity that is all of the following:
    - The annuity is irrevocable and nonassignable.
    - The annuity is actuarially sound.
    - The annuity provides for payments in equal amounts during the term of the annuity, with no deferral and no balloon payments made from the annuity.

The burden of demonstrating that the requirements of limiting the state's right to becoming a remainder beneficiary falls upon the individual or the community spouse, or both (Sec. 14009.7 of the Welfare and Institutions Code).

CSRA
A Medicaid applicant’s spouse should not become impoverished, according to federal law. One protection for the spouse is the community spouse resource allowance. The community spouse resource allowance (CSRA) gets its name because it is an allowance of resources (money or other assets) that the community spouse (the husband or wife of a Medicaid applicant) can keep and not have to spend down to qualify for benefits. The CSRA is usually applied for after the applicant enters a nursing facility, and is based on what the couple’s resources are worth on date of admission. In general, the CSRA is half of the couple’s resources, after excluding those that are exempt under Medicaid rules.

Transfer of Assets Rule
Section 14015(a)(1) of the California Insurance Code states that the providing of health care under this chapter does not impose any limitation or restriction upon the person's right to sell, exchange or change the form of property holdings nor does the care provided constitute any encumbrance on the holdings. However, the transfer or gift of assets, including income and resources, for less than fair market value can result in a period of ineligibility for medical assistance for home and facility care, which may include partial months of ineligibility, applied in accordance with federal law. This sanction is in accordance with the requirements of Title XIX of the federal Social Security Act (42 U.S.C. Sec. 1396 et seq.) and any regulations adopted pursuant to that

act.

Any items, including notes, loans, life estates, or annuities that are held and distributed in a manner that is not in conformity with the requirements of Title XIX of the federal Social Security Act (42 U.S.C. Sec. 1396 et seq.) and regulations adopted pursuant to that act, are treated as transferred assets and may result in a period of ineligibility as required by Title XIX of the federal Social Security Act (42 U.S.C. Sec. 1396 et seq.).

Demonstration that assets transferred exclusively for a purpose other than to qualify for medical assistance does not result in ineligibility for Medi-Cal and includes, but is not limited to, the following:

- Assets that would have been considered exempt for purposes of establishing eligibility pursuant to federal or state laws at the time of transfer.
- Property with a net market value that, when the property is transferred, if included in the property reserve, would not result in ineligibility.
- Assets for which adequate consideration is received.
- Property upon which foreclosure or repossession was imminent at the time of transfer, provided there is no evidence of collusion.
- Assets transferred in return for an enforceable contract for life care that does not include complete medical care.
- Assets transferred without adequate consideration, provided that the applicant or beneficiary provides convincing evidence to overcome the presumption that the transfer was for the purpose of establishing eligibility or reducing the share of cost.

In administering this section, it is presumed that assets transferred by the applicant or beneficiary prior to the look-back period established by the department preceding the date of initial application were not transferred to establish eligibility or reduce the share of cost. These assets are not to be considered in determining eligibility. Any item of durable medical equipment which is purchased for a recipient pursuant to this chapter exclusively with Medi-Cal program funds is to be returned to the department when the department determines that the item is no longer medically necessary for the recipient. Items of durable medical equipment include, but are not limited to, wheelchairs and special hospital beds. This section gets implemented pursuant to the requirements of Title XIX of the federal Social Security Act (42 U.S.C. Sec. 1396 et seq.) and any regulations adopted pursuant to that act, and only to the extent that federal financial participation is available.

To the extent that regulations are necessary to implement this section, the department can promulgate regulations using the nonemergency regulatory process described in Article 5 (commencing with Section 11346) of Chapter 3.5 of Part 1 of Division 3 of the Government Code. It is the intent of the Legislature that the provisions of this section apply prospectively to any individual to whom the act applies commencing from the date regulations adopted pursuant to this act are filed with the Secretary of State.

E. Effect of Annuity Income on Medi-Cal Threshold

An annuity is income for Medi-Cal purposes and income affects program eligibility. In addition to covering individuals who receive cash assistance from the government, Medi-Cal offers health care coverage to individuals and families who have incomes too high to qualify for welfare, but too low to cover health care costs. Medi-Cal requires some of these recipients to contribute to their health care by paying a share of the cost of the services they receive. Once a recipient's health care expenses reach a predetermined threshold (the "share of cost"), Medi-Cal will pay for any additional covered expenses for that month. Share of cost is an amount owed to the health care provider, not to the state.

The well spouse can keep all of his or her own income and sometimes some or all of the institutionalized spouse's income. California law states that there is a "minimum monthly maintenance need allowance" ($3,090 for 2018) which is increased each year. What it means is that if the at home spouse does not have her own income or gets very little, and then she can keep up to $3,090 of the institutionalized spouse's income. For example, if the well spouse gets $1,000 of her own income, she can keep $1,841 of nursing home spouse's income accordingly. The Long-Term Care maintenance need level (i.e., personal needs allowance when someone is in a nursing home) is $35 monthly for each person.

Annuities secure a stream of immediate or deferred payments. As pointed out elsewhere in the book, the Medi-Cal program addresses how annuities are handled in determining an individual's eligibility for the program. Deferred annuities are counted as available resources by the Medi-Cal program. An annuity in the payout stage (annuitized amount) is not counted as a resource but does count as income and will have to be used towards share of cost if eligibility is established.

F. Duty of Honesty, Good Faith, and Fair Dealing: Breach of Duty

All actors on the insurance industry side of the insurance market owe a duty of honesty, good faith, and fair dealing to the public in general and to people 65 or older in particular. This duty is separate and additional to any other duties. Agent conduct with consumers is relevant to any action that involves breach of the duty of good faith and fair dealing. This standard of conduct applies to Medicare supplement, long-term care, disability, and accidental death insurance only as specifically stated (Section 785 of the California Insurance Code).

XI The Senior Market

How are senior citizens doing financially? In answering this question, it is a mistake to assume that all senior citizens are wealthy; it is equally wrong to assume that all seniors are poor. Seniors are an economically diverse group, and the incomes received are far from uniform.
In 2014, 11.4% of seniors 65 and older had incomes under $10,000. At the other end of the spectrum, 31.5% of seniors had incomes of $50,000 or more. The median income for all seniors in 2014 was $30,193. This amount is relatively low and may be insufficient for those with substantial additional expenses, such as high or uninsured medical bills, the cost of long-term care in a nursing home, or high property taxes. In addition many seniors live in poverty. In 2014, 10% of senior citizens had incomes below the poverty line. (US Census Bureau Data*)*

A. Market Volatility, Risk Tolerance and the Senior Client

Related to investments, volatility is a measure for variation of price of a financial instrument over time. Historic volatility is derived from time series of past market prices. Investors care about volatility for several reasons:

- the wider the swings in an investment's price the harder emotionally it is to not worry
- when certain cash flows from selling a security are needed at a specific future date, higher volatility means a greater chance of a shortfall
- higher volatility of returns results in a wider distribution of possible final portfolio values

A higher volatility of return when retired gives withdrawals a larger permanent impact on the portfolio's value. With a shorter time horizon and reduced earning power to make up for potential losses, seniors tend to shy away from investments with the possibility of wide price swings.

Risk tolerance is the degree of uncertainty that an investor can handle in regard to a negative change in the value of his or her investment portfolio. An investor's risk tolerance varies according to age, income requirements, financial goals, etc. Risk is traditionally defined in terms of uncertainty, the uncertainty concerning the occurrence of a loss. People by and large perceive most of the financial risks they might face in retirement, but are at best imprecise in their evaluation of them and are reluctant to spend significantly on preventatives. Risks associated with retirement include:

- Longevity risk- retirees may drawdown benefits too quickly and outlive their assets. Conversely, retirees may drawdown their benefits too slowly, unnecessarily reduce their consumption, and leave more wealth than intended when they die.
- Investment risk- assets in which pension savings are invested may decline in value.
- Inflation risk- inflation may diminish the purchasing power of a retiree’s pension benefits.

The major risks related to old age are insufficient income during retirement and the risk of outliving one’s assets. When workers retire, they lose their normal work earnings. Unless they have accumulated sufficient financial assets on which to draw, or have access to other sources of retirement income, such as Social Security or a private pension, they will be confronted with a serious problem of economic insecurity. Retired persons generally own insufficient financial assets. Financial assets are important since investment income can supplement any retirement income, and the assets provide a cushion for emergencies.

B. Pre-retirement vs. Post-retirement Planning

The pre-retirement stage of life can cover the years from age 50 to age 65. During this time of life, families become "empty nesters," and their children have moved into adulthood. Beside the feelings wrought by such a change, the reality is that the years have passed quickly and that retirement is on the horizon. For many working adults, their first serious efforts at financial planning for retirement begin during these years. No matter what the age, there is great truth in the principle that it is "never too early to begin planning your retirement finances." When an individual faces the idea of planning, the following questions should be asked about pre-retirement financial planning.

How Much Money Will be Needed in Retirement? – People need to plan on living on less money in retirement. But the good news is that many expenses may be reduced. For instance, a person may need to maintain only one car and may have a reduced need for business attire and entertainment obligations. Housing requirements can normally be reduced as well. In these ways, as well as many others, expenses can be reduced significantly. A goal can be set of initially having a minimum of 70 to 75 percent of pre-retirement income coming in at retirement. Adjustments should be made gradually rather than suddenly. Begin living on less 3 to 5 years prior to retirement. Finding corners that can be cut, without reducing the quality of life, can be a challenging, but very rewarding, adventure in pre-retirement planning.

Projecting Retirement Income- Generally, retirement income will consist of Social Security benefits; pension and/or retirement savings plan benefits, interest and dividend income from personal savings, and post-retirement earnings. Institutions that sell or sponsor retirement savings vehicles can help estimate projected benefits from retirement plans. The Social Security Administration provides a Social Security Statement that can assist in estimating future Social Security benefits. It is important to check Social Security income records for accuracy on a regular basis. Errors cannot be corrected after a certain amount of time.

The local Social Security office can assist in estimating future Social Security benefits. The accuracy of Social Security income records should be checked every 3 years. By calling the Social Security Administration number (1-800-772-1213), individuals may request a form to check their records at no charge.

Inflation is a significant problem for anyone on fixed incomes, because purchasing power diminishes as prices rise. Social Security has a built-in cost-of-living factor, its future may be in doubt in light of federal deficits and future Social Security tax increases to support the system. Inflation affects other fixed income sources as well. Long-term inflationary trends are very difficult to project, but cannot be ignored. The best approach is to put aside as much money as possible before retirement. It is also important that the earnings or returns on invested assets be greater than inflation. Otherwise, the real value of the investment declines.

Post-retirement planning has a commonality with pre-retirement planning; husbanding of financial resources. This is important because the individual has stopped working; there is no stream of income to supplement savings. Many individuals will face a financial emergency in the retirement years. As preparation, attempts should be made to have a sum set aside in an interest-bearing account. A commitment should be made that these emergency funds are only for a *real* emergency. Small consumer loans and credit cards may be convenient sources of emergency funds, but they carry a very high cost. An adequate emergency fund can eliminate the additional expense of interest. The fund is used only as "a last resort" and every effort should be made to replenish it after it has been accessed.

C. Financial Concerns

1. Social Security

Here is the economic definition of social security: A system of government-financed income transfers designed to effect a distribution of income considered desirable. The main component of most social security systems is welfare benefits, given to those in poverty. It can be done two ways: 1.) by identifying groups that are likely to be poor (the unemployed, the elderly, and the disabled), and giving benefits to them irrespective of their actual income; 2.) by identifying, through some sort of standard, people who are poor.

The Social Security program in the United States is an offshoot of option one above. It is officially called the Old-Age, Survivors, Disability, and Health Insurance (OASDHI) program. Almost 95 of 100 workers are employed in occupations covered by Social Security. There is continued worry that this vast program will eventually run out of money. Still, it keeps on making regular payments to millions of Americans and will (hopefully) continue to do so. The political and economic fallout from a collapse of Social Security is almost unimaginable. The program usually begins payment at age 65, but starts at earlier ages for blind or disabled people. The earlier benefits are at a reduced rate.

Social Security and Retirement Planning- As related to retirement, the social security program extends benefits to various classes of family survivors of covered wage earners. Payments are not based on the earnings record of the survivors. It cannot be stressed enough the importance of these benefits. It is the responsibility of the breadwinner’s survivors to take maximum advantage of the benefits offered. The reality is that for the vast majority of Americans estate planning consists of applying for social security benefits. The U.S. has an abysmally poor savings rate. For whatever reason, most people live beyond their means. A somewhat larger share of the population can expect both social security benefits and a life insurance payment upon the death of the breadwinner. This is a step in the right direction. The public needs to begin planning. Conservation of a few dollars can result in peace of mind and a more comfortable situation for survivors upon death of the breadwinner.

2. Retirement Plan Distributions

“Danger: Lump-Sum Distribution Recipient” Perhaps a placard with this *malis avibus* should be worn by all who receive a large payment from a retirement plan. Surely such a scarlet letter would scare off hucksters, fast buck artists, and conjurors of good deals that materialize when payout occurs. Instead of the sign, those who receive retirement plan distributions should instead be cautious and prudent in their actions. The axiom says, “You will always run out of money before you run out of good deals.” This is money that took a career to accumulate; plenty of thought should go into redeploying the assets.

There are a number of options as to how retirement plan distributions can be taken. This would include a worker’s vested share of company or Keogh pension or profit-sharing plans (including thrift and savings plans), 401(k)s, IRAs, and stock bonus plans. The options depend (1) on what type of plan the individual is in and (2) whether the employer has limited the plan choices. Essentially, what can be done is:

1. Take everything in a lump sum.
2. Take some kind of annuity.
3. Roll over the distribution.
4. Take a partial withdrawal.
5. Do some combination of the above.

Federal law generally protects retirement assets or accounts against claims of creditors so long as the assets remain in the retirement plan. Exceptions to that protection include unpaid federal taxes, IRA’s, Keogh plans where the Keogh owner (or owner and spouse) are the only ones in the plan. Annuities are safe from all creditors except the IRS.

3. Investing Retirement Assets

If a lump-sum distribution from a qualified retirement plan is received, what is done with the money has an effect on the tax status of the benefits:
First, no tax is due on any portion of the payment that represents the participant’s cost of the plan, premiums paid or after-tax contributions that were made.
The payment can be rolled over into an IRA or another qualified plan. The amount that represents the investment in the contract is not eligible for a rollover, however. The rest (that shown as the taxable amount in Box 2a of Form 1099-R) can be rolled over into an IRA.
Receive the payment in cash, with none of it rolled over. The taxable portion of it will be taxed as ordinary income in the year it is received.
Pay an extra 10% tax penalty if the distribution was made prematurely, generally before age 59½. In any case, 20% of the payment will be withheld for income taxes.

D. Insurance Concerns

1. Health

Poor health is an important personal risk that grows larger as a person ages. The risk of poor health includes both catastrophic medical bills and the loss of earned income. If retired, there is not the promise of going back to work to pay off bills. Hospitalization costs do not stop rising. Unless someone has adequate health insurance or other sources of income to meet these expenditures, financial insecurity or bankruptcy can result.

Insurance needs change significantly with age. In the health arena, surveys confirm that many retirees worry about having a major illness with inadequate hospitalization benefits. It must be understood that Medicare provides both hospitalization insurance and medical insurance. The medical insurance portion is optional and, a monthly premium for it is paid to Social Security. Medicare does not pay for everything and the plan has undergone, and will continue to undergo, many changes. Many private insurance companies offer "Medigap" policies that supplement Medicare. Congress has established federal standards for such policies. Individuals choose from a standard list of ten Medigap packages. Of course, the more comprehensive packages cost more. Life insurance needs change drastically with retirement. At retirement, the primary purpose for purchasing life insurance no longer exists. There is no worry about protecting dependent survivors from the loss of income between the time of death and the time income would have ceased at retirement. If a person has sufficient cash resources to cover final expenses and burial, then there is not much reason for life insurance.

2. Long-Term Care

During the working years little thought is given to the financial consequences of long-term disability. The chronic conditions that bring about the need for long-term care at home or in a nursing home can be very expensive. Chronic care differs substantially from what most people associate with medical care. <u>Acute</u> care uses intensive, hospital-based, and often high technology medical services to cure acute manifestations of a disease or injury. <u>Chronic</u> care seeks to enable people with functional limitations to regain or maintain the highest level of independence and functioning possible. Chronic care typically provides both medical care and non-medical assistance from a wide range of caregivers in a variety of settings. Because chronic conditions by definition cannot be fully cured, chronic care also emphasizes long-term assistance and compassionate care. Long-term care insurance is available to prevent the loss of assets resulting from chronic conditions, resulting in a penniless old age.

3. Estate Planning

Insurance is one of the most important components of the estate planning process. There is no such thing as an estate where life insurance could not be an integral part. This is so because life insurance is relatively inexpensive, provides an instant estate, is flexible and is a familiar, easily understandable concept for even the most inexperienced client in estate planning. The reality is that, like estate planning, life insurance is one of the consumer’s least favorite topics of discussion. The most obvious reason to buy life insurance is to provide liquidity to pay debts, funeral expenses, taxes, or to provide support for beneficiaries. This is especially true if assets are illiquid in that they cannot be turned into cash readily. This situation is often found with owners of real estate, small businesses, or partnership interests. At death, these assets need to be managed, maintained, and have the mortgages paid. This causes a quick drain of cash. Whether an estate is worth thousands or millions, the use of life insurance is the same: To pay off bills and give the family breathing room after the insured’s death. This is especially so when the insured is the family’s breadwinner and the death terminates the income flow. Insurance has been a part of estate planning for a long time. When a provider’s estate is not large enough to provide for dependents, life insurance does the job.

E. Selling to the Senior Market

The potential of the senior market is huge and growing rapidly. If adults age 65 and over are included, the senior market is projected to exceed 72,000,000 by the year 2030, based on U.S. Census data. This has significant bearing on both for-profit and non-profit marketing efforts. Seniors and pre-retirees who plan now by building the best asset management strategy will reap the greatest benefit from those who market financial products to seniors. Senior-focused selling, active networking and focusing on senior needs, will provide for growth in this market. An understanding the dynamics of this market will benefit the insurance industry. It will also be of assistance to seniors, who will have more information and product choice at their disposal.

Gray hair is appearing at an ever-increasing clip in the workplace. Senior Americans comprise 10 percent of the workforce, but account for 22 percent of the nation's job growth. By 2024, Bureau of Labor Statistics projects that the labor force will grow to about 164 million people. That number includes about 41 million people who will be ages 55 and older-of whom about 13 million are expected to be ages 65 and older. And, although they make up a smaller number of workers overall, the 65- to 74-year-old and 75-and-older age groups are projected to have faster rates of labor force growth annually than any other age groups. The senior market is as deep as it is wide. One of its more interesting characteristics is its diversity. In 1996, the baby boomer generation of approximately 78 million began turning 50 at the rate of 300,000 per month. In an unprecedented paradigm shift, both parents and their children are now members of the senior population, with ages ranging from 50 to over 100 and experiences ranging from the Great Depression to Woodstock.

Application of basic sales principles to the senior market should play a key role in a thorough marketing plan with the greatest potential for success. Here are ten key points to remember in dealing with the senior market;

1. Never think that the elderly market is “old.” They do not consider themselves old.
2. Never attempt to scare them into buying. Scare tactics turn people off.
3. Always treat them as equals
4. Do not pander or be obsequious. Never talk down; they are not dumb. In fact, they are probably smarter -and richer -than you.
5. Do not hoodwink or con. Seniors are skeptical; they have seen it all before.
6. Do not paint all seniors with a broad brush; they are not all alike. There are several age cohorts above age 50 and numerous niche markets.
7. Guarantees are taken seriously. Seniors fear being taken.
8. Glitz and gaudiness have no place. Seniors are conservative about expenditures as a result of being on fixed incomes.
9. Ads should look like ads. No elaborate *fonts*. Type should be at least 12 point in an easy to follow format, not condensed or spread.
10. As with any other client, treat seniors with respect.

1. Product complexity

The stage may be set for a national crisis in retirement planning, as many seniors are underestimating their own longevity and are not saving enough for retirement, according to a recent survey[10]. Questions were designed to test participant's knowledge of retirement and income planning statistics and issues involving longevity and its impact. Consumers are underestimating their own longevity and not saving adequately for their retirement, and this sets the stage for a national crisis in retirement planning. Individuals aged 56 to 65 within at least five years of retirement were asked to respond to a quiz designed to test their knowledge of retirement and income planning statistics and issues in the areas of:

- Longevity and its impact
- Income, expenses, and inflation in retirement
- Annuities as a retirement planning tool
- Long-term care and protection of assets

On average, respondents answered only five of the fifteen questions correctly. This failing score of 33% suggests that seniors have misconceptions about issues affecting their retirement. Specifically, they underestimated the life expectancy of a 65-year old (and how many years they are likely to spend in retirement), and they do not consider longevity a significant financial risk in terms of appropriately planning for their retirement. Further, their answers revealed that they underestimate how much money they should be saving compared to experts' recommendations and that they may intend to withdraw from their retirement savings at levels considered too high. They demonstrated a lack of understanding of the extended time horizon they would be living in retirement and of inflation's full effect on the future value of their money. Their responses also indicated that they underestimate long-term care expenses and do not fully understand annuities – the primary insurance product designed to protect retirees' income.

Cost Factors in Resource Allocation-In a dynamically changing economic environment, holding on to assets can become as cutthroat as survival in one of the reality-based television shows; which means that seniors have to continually be on their toes. They must anticipate and assess their need for new products or services in order to stay ahead of the game. Faced with the dilemma of unlimited strategic choices but limited resources, seniors must seek help from representatives of the financial services industry to assist them find the best course of action. There are a variety of consumer costs associated with purchasing insurance or financial products. Product complexity can lead down the path of incorrect decisions and the purchase of incorrect or overpriced annuities or consumer products. Greater product complexity is driven by an increased volume and diversity of offerings. Straight-life to variable to second-to-die policies are offered by indirect sales, product seminars, and personal sales calls from anybody who can squeeze a name out of a database.

Take banks as an example, with changes brought about by the Gramm-Leach-Bliley Financial Services Modernization Act of 1999, insurers gained new access to customers of banking institutions. Even at relatively low penetration rates, a substantial volume of low cost business can be generated by the bank customer list. Furthermore, insurance product complexity makes the sale of insurance products more difficult for new channels, and experience suggests that tenure in product marketing is a strong contributor to success. Product integration is the holy grail of both 'one stop shopping'

[10] The "MetLife Retirement IQ Test" was developed by the MetLife Mature Market Institute and in May 2003 surveyed 1,201 men and women between the ages of 55 and 65 who are within five years of retirement.

and ‘financial services convergence’. Consumers clearly seek convenience, performance, and trust in their contemporary buying habits. Product proliferation, with or without profit subsidization from one product to another, is unlikely to be a sustainable market strategy. Linking financial services products in a seamless, efficient package, designed for particular market segments and life cycle needs, has great conceptual and ‘street’ appeal. Whether or not the cost of delivering such a program of services, principally driven by the technology requirements, is anybody’s guess.

2. Surrender Charges

Annuity contracts carry a surrender charge. A typical contract could have a surrender charge in effect over the first 10 years, but decreasing in amount each year. The contract will explain how the surrender charge applies. An annuity is a long-term investment. The surrender charge discourages the annuity owner from using the funds as a piggy bank. It also allows the insurer to cover the expense of selling and issuing the contract. The charge is usually a percentage of either the fund’s accumulated value or the total premiums paid. Surrender charges are generally waived under certain circumstances, such as death or disability of the annuitant.

Annuity contracts for senior citizens that contain a surrender charge period need to disclose the surrender period and all associated penalties in 12-point bold print on the cover sheet of the policy or disclose the location of the surrender information in bold 12-point print on the cover page of the policy, or printed on a sticker that is affixed to the cover page or to the policy jacket. The notice required by this section may appear on a cover sheet that also contains the disclosure required by subdivision (d) of California Insurance Code Section 10127.10, which be found in the “Free Look Period,” of this book. (Section 10127.13 of the CIC)

3. Issue of Buyer Competence

a. Short term memory/judgment

A requirement of SB 620 (passed in 2003) is that, effective January 1, 2005, agents must satisfactorily complete eight hours of training before selling annuities. This training will cover, among other topics, prohibited sales practices and ways to recognize that a senior may lack the short-term memory and judgment needed to assess a policy or annuity. The brain's ability to learn and remember recent events can change over time due to any number of reasons. Researchers and doctors working with diseases like Bipolar depression and Alzheimer's are finding out that the brain of a disease victim suffers decrements (reductions) in its short-term memory and learning capacities.

Insurance agents are now charged by the legislature to make objective evaluations as to the ability of an individual to contract. Examples of short-term memory capability test indicators include the following;

- Count backwards from 100 by sevens- Thus, 93, 86, 79, 72, 65, … and so on.
- “I am going to say three words- bacon, brown, skillet.” (Any three words will do, but associated words are acceptable.) “We will discuss other matters for a few minutes, and then you will need to recite the words back to me.”

These short-term memory test indicators are for illustrative purposes only. Any tests or indicators should be previewed and probably approved by a representative of the insurance company the agent is representing.

b. California Civil Code §38 & 39

Consider the case where the ‘indicators’ show “…that a prospective insured may lack the short-term memory or judgment to knowingly purchase an insurance product…” What is the agent to do? Someone who completely lacks the powers of understanding is not capable of making a contract, except that the individual is statutorily liable for the value of necessities furnished under a contract. Necessities mean such things as groceries and rent, not insurance. (California Civil Code Section 38)

Substantial inability may not be proved solely by isolated incidents of negligence or improvidence. (California Civil Code Section 39)

A senior who may exhibit short-term memory loss would not seem to fall into the *non compos* class. However, an insurance contract made by a person of unsound mind before a judicial determination of incapacity has been determined, is subject to rescission. Bolstering the case for such a rescission would be proof that a person is substantially unable to manage their financial affairs or resist fraud or undue influence. A person lacking sufficient mental capacity to enter into a contract is not held competent even if he has not been judged insane by a court. He or she is one who is unable to understand the effect and nature of their act in making the agreement. An insane person's voidable contract can be ratified or disaffirmed when he or she is again sane, or by the guardian during insanity or his or her representative after death.

c. Family Involvement / Power of Attorney

In the context of buyer competence, family involvement is important. In terms of assets, senior investors have much to lose when they start losing cognitive abilities. This means both a big responsibility and an opportunity to help for family members. There are legal and financial tools the elderly can use to protect themselves, and it is important to start early. An effective buttress to establish before cognitive decline begins is a power of attorney. Ideally, the family should not wait until cognitive functioning declines to discuss these long-term strategies, but rather they should get going while the senior is still cognitively healthy.

4. Unique Ethics and Compliance Issues

Complexity and competence issues as discussed above put the agent in an evaluation/judgment quandary requiring the skills of King Solomon. Is this product too complex for understanding? Is a particular senior citizen lacking the memory skills to comprehend what is being presented? The way to avoid problems in this area is to employ safeguards ethical safeguards:

- **Document client files-** A properly documented file contains complete and accurate accounts of client-agent interaction. This allows the agent to properly account for the need for insurance and substantiates the reason for the sale.
- **Change can cause problems-** With any new product or change in law, seek professional legal opinions as to proper procedure. Insurance providers will no doubt

have promulgated procedures they feel are appropriate in dealing with seniors when selling a particular product.

- **Service is essential-** Transparency and self-policing, honesty and forthrightness are items hard to quantify, but an agent who maintains a checklist of integrity will seldom have to regret any action he or she has taken.

5. Suitability for the Senior Market

Insurance professionals must consider, among other things, tax consequences, surrender charges and loss of benefits (such as death, living or other contractual benefits). An insurance professional cannot adequately determine the suitability of a transaction without knowing the material features of the annuity in question. An agent's understanding of the features of an annuity product is an important component of two concepts;

1. That, the agent determine, after appropriate due diligence, whether the product is suitable for at least *some* investors.
2. That the agent determines whether the product is suitable for the particular customer at issue (customer-specific suitability).

It is important that seniors are not deceived into tying up their money in long term annuities when they cannot pay their living expenses, and are fully aware of the products they are purchasing. Agents should utilize comprehensive procedures to ensure better senior protection;

- Conduct an elevated review on all applications submitted from specified individuals 65 years and older
- Follow up by telephone with all applicants seventy-five years of age or older, and those living in assisted living facilities, to confirm their thorough understanding of the purchased product
- Amend annuity contracts to make them more understandable to consumers
- Clearly, plainly, and conspicuously disclose the terms of premium bonuses being offered

XII Penalties

Here is a listing of penalties for insurance licensees in California who want to violate or circumvent proper sales practices. See Attachment III for further discussion.

1. Violation of Provisions in Section 780 or 781 of the CIC

An insurer or agent must not misrepresent the terms of a policy issued or promised to be issued by the insurer, the benefits or privileges agreed to in the policy, or the future dividends payable under the policy. Insurers or their representatives must not make any statement that is known, or should have been known, to be a misrepresentation of the following:

- The terms of a policy issued by the insurer or sought to be negotiated by the person making or permitting the misrepresentation
- The benefits or privileges promised

- The future dividends payable

Agents must not use falsehood or misrepresentation to persuade a policyholder to lapse, forfeit or surrender his or her insurance. Conversely, insurers and their agents may not use any representation or comparison of insurers or policies to an insured which is misleading, for the purpose of inducing or tending to induce him to lapse, forfeit, change or surrender his insurance, whether on a temporary or permanent plan (Section 780 and 781 of the CIC).

Any person violating the provisions of Sections 780 or 781 can be punished with up to one year in jail and/or a fine up to $25,000. Where a victim's loss is over $10,000 the fine can be up to three times the amount of loss. Victim restitution gets satisfied before any fine is collected. (Section 782 of the CIC).

2. Administrative Penalty, Amounts, Rescission of Contracts

Persons engaged in transactions of insurance, other than an insurer, who violate the rules regarding sales practices for agents are liable for an administrative penalty-
For the first violation, it is no less than $1,000. A second or subsequent time an agent commits a knowing violation of this article, he or she is liable for an administrative penalty of no less than $5,000 and no more than $50,000 for each violation.

If an action is brought against a licensee as in the previous paragraph and it is determined that the licensee may reasonably be expected to cause significant harm to seniors, the commissioner may suspend his or her license pending the outcome of a hearing made available to the licensee.

Insurers who violate the articles relating to sales practices are liable for an administrative penalty of $10,000 for the first violation. Insurers who violate this article with a frequency as to indicate a general business practice or commits a knowing violation of this article, is liable for an administrative penalty of no less than $30,000 and no more than$300,000 for each violation.

The commissioner may require rescission of any contract found to have been marketed, offered, or issued in violation of Insurance Code articles pertaining to good sales practices. (Sections 789.3 of the CIC)

3. Allegations of Misconduct Against a Person 65 Years or Over

A proceeding that involves allegations of misconduct committed against a person age 65 or over is to be held within 90 days after receipt by the department of the notice of defense, unless the department or the administrative law judge grants a continuance of the hearing. Under certain circumstances, a continuance of the hearing may be granted (Section 1738.5 of the CIC).

4. Administrative Penalties

Anyone other than an insurer, who violates the provisions of Chapter 4 Article 8 of the California Insurance Code (requirements for replacement of life insurance and annuity policies) is liable for an administrative penalty of no less than one thousand dollars

($1,000) for the first violation. A second or subsequent violation earns an administrative penalty of no less than five thousand dollars ($5,000) and no more than fifty thousand dollars ($50,000) for each violation. Insurers who violate the provisions are liable for an administrative penalty of ten thousand dollars ($10,000) for the first violation. Insurers violating the provisions with a frequency as to indicate a general business practice is liable for an administrative penalty of no less than thirty thousand dollars ($30,000) and no more than three hundred thousand dollars ($300,000) for each violation. After a hearing, the commissioner may suspend or revoke the license of any person or entity that violates this article. (Section 10509.9 of the CIC)

XIII. California Life and Health Insurance Guarantee Association and Annuities

The California Life & Health Insurance Guarantee Association is a statutory entity created in 1991 when the California legislature enacted the California Life and Health Insurance Guarantee Association Act (comprises Section 1067-1067.19 of the CIC). The guarantee association is composed of all insurers licensed to sell life insurance, health insurance, and annuities in the state of California. In the event that a member insurer is found to be insolvent and is ordered to be liquidated by a court, the Guarantee Association Act enables the guarantee association to provide protection (up to limits) to California residents who are holders of life and health insurance policies, and annuity contracts, with the insolvent insurer.

Specifically, when a member insurer is found to be insolvent and is ordered liquidated, a special deputy receiver takes over the insurer under court supervision and processes the assets and liabilities through liquidation. The task of servicing the insurance company's policies and providing coverage to California's resident policyholders becomes the responsibility of the guarantee association. The protection provided by the guarantee association is based on California law and the language of the insolvent company's policies at the time of insolvency. For further information the Guarantee Association's website is;

http://www.califega.org

The information at the website, as well as in this section, is for general information purposes and should not be relied upon as legal advice.

When an insurance company goes out of business; In most cases, a guaranty association will continue coverage as long as premiums are paid or cash value exists. It may do this directly, or, it may transfer the policy to another insurance company. The policy may also be cancelled in accordance with its policy provisions and applicable law. In any case, policyholders should continue making premium payments to keep their coverage in force.

Companies covered by the California Life and Health Insurance Guarantee Association (Guarantee Association); The California Life and Health Insurance Guarantee Association provides coverage to owners of covered policies issued by member insurers (life, health, and annuity insurers licensed to write business in

California). To determine if a company is licensed to write business in California, consumers can call the California Department of Insurance at (800) 927-4357, or (213) 897-8921 from the Los Angeles area. The Department maintains current records of all insurance companies licensed to do business in California. Information about companies licensed to write insurance in California may also be obtained from the Department of Insurance Website; www.insurance.ca.gov.

Claim procedure with the California Life and Health Insurance Guarantee Association: If their insurance company is liquidated, the policyholder will receive a notice from the court-appointed Receiver (typically the Insurance Commissioner of the company's state of domicile), who will oversee the liquidation of the company and inform policyholders of any new claims procedures. There may be no change in the claims submission process—guaranty associations, working with the Receiver, sometimes continue processing claims using the liquidated company's existing claims staff if that will maximize the speed and efficiency with which claims are processed. In other cases, the associations process the claims themselves or use an independent processing company, known as a third-party administrator, to process claims. In any event, claimants will be notified of the ongoing claims process.

Policy coverage: Coverage is determined by California law and policy language at the time the Guarantee Association is activated to provide protection. Generally, this occurs when the member insurer is found to be insolvent and ordered liquidated by a court. In light of changes in the law and the dramatic variations in policy language, the association cannot make statements regarding coverage of a specific policy unless it is a policy with a company for which the association has been activated to provide protection.

How protection is provided: Protection can be provided in several different ways. The Guarantee Association may provide coverage directly. Or, a financially sound insurer may take over the insolvent company's assets and policies, and assume responsibility for continuing coverage and paying covered claims. In some situations, the Guarantee Association may work with other state guaranty associations to develop an overall plan to provide protection for the insolvent insurer's policyholders. The amount of protection provided and when received depends on the particular arrangement worked out for handling the insolvent insurer's obligations.

Types of plans, policies, and benefits not protected by the California Life and Health Insurance Guarantee Association: Policies sold by insurers not licensed to do business in California; policies issued by medical, health, or dental care service corporations; managed care plans; self-insured employer plans; fraternal benefit society insurance certificates; policy benefits the insurer does not guarantee such as the non-guaranteed portion of a variable life insurance contract sold by prospectus, or benefits for which the individual policyholder has assumed the risk of loss; guaranteed interest rate yields that exceed the rate specified by the California Life & Health Insurance Guarantee Association Act; most unallocated annuity contracts; and charitable gift annuities. Policyholders finding themselves unsure whether the policy is protected should contact their insurer.

Variable annuity coverage and the guaranty association: A variable annuity contract with general account guarantees may be eligible for guaranty association coverage only to the extent of its general account guarantees. Non guaranteed elements of variable products are not covered by the Guarantee Association. Any coverage is subject to applicable limits and exclusions. Specific questions regarding coverage will be determined by the applicable guaranty association based on the terms of the contract, other relevant facts, and the guaranty association law in effect at the time of liquidation.

Policy status when benefits promised are greater than the coverage limits provided by the Guarantee Association: In general recoverable benefits are limited to the amounts set by law. However, guaranty associations, in conjunction with the Receiver, may be able to negotiate a transfer of a company's policies, up to the amount of the guaranty association benefit limits, to a financially sound insurer. If an association administers claims against the policy and the benefit limits are reached, any claim in excess of that limit may be submitted as a policyholder-level claim against the estate of the failed insurance company, and such policyholder may receive distributions as the company's assets are liquidated by the Receiver.

Coverage of life insurance and annuity policies: The maximum amount of protection for which the Guarantee Association may become liable for life insurance and annuity policies is as follows:

- **Life insurance death benefit protection**: 80% of the policy death benefit up to a maximum of $300,000
- **Life insurance net cash surrender and net cash withdrawal values**: 80% of the policy value up to a maximum of $100,000
- **Present value of annuity benefits including net cash surrender and net cash withdrawal values**: 80% of the present value up to a maximum of $250,000.

Life insurance benefits including net cash surrender and net cash withdrawal values, and annuity benefits including net cash surrender and net cash withdrawal values are subject to interest rate adjustments. Generally, interest rate reductions are made when an insolvent insurer promised a rate of interest in excess of that provided for in the California Life & Health Insurance Guarantee Association Act. The maximum total amount the Guarantee Association will provide for any one individual for life insurance and annuity coverage is $300,000, even if that individual is covered by multiple life insurance policies and annuities.

Guarantee Association effect on the status of claims against an insolvent insurer: If a policyholder receives benefits from the Guarantee Association, he or she is deemed to have assigned rights under the covered policy to the Guarantee Association to the extent of benefits received. The Guarantee Association may require an assignment of such rights prior to providing benefits to any person. The law provides that the Guarantee Association is a creditor of the insolvent insurer to the extent of assets attributable to covered policies. Also, the Guarantee Association has the right of subrogation, and the other equitable and legal remedies available to the policyholder.

Annuity amount protected: If an individual purchased three annuities each worth $250,000 from a company that becomes insolvent, only $250,000 is covered. That is the maximum amount protected by the Guarantee Association for all annuities you purchased from a single insurer.

Status of a married couple where each has an annuity contract worth $200,000: The limit applies to each spouse separately; each would have a combined total protection of up to $320,000. Each spouse receives $160,000 (80% of $200,000).

Interest rate adjustments could further reduce the amount of recovery.

Status of an Individual Retirement Annuity (IRA): Assuming all other conditions are met, it is protected up to the limit set for an annuity.

Projected wait time to receive the protection provided by the Guarantee Association: The Guarantee Association will endeavor to provide protection as promptly as possible. Delays are sometimes necessary to sort out the affairs of the insolvent insurer. As a result, policyholders may have to wait several months before receiving the protections provided by law.

Sources of funds with which the Guarantee Association provides protection: The law authorizes the Guarantee Association to assess all life and health insurance companies licensed to do business in California for the funds necessary to provide the protection. No tax dollars are used to provide this protection.

Residency: The Guarantee Association limits protection to policy owners who are residents of California at the time the insurance company becomes insolvent. If a policy is purchased from a company that is a member insurer of the California Life and Health Insurance Guarantee Association, coverage is provided. Guaranty association protection is generally provided by the association in an individual policyholder's state of residence at the date of the liquidation order regardless of where the policy was purchased. Policyholders who reside in states where the insolvent insurer was not licensed are covered, in most cases, by the guaranty association of the state where the failed company was domiciled. Generally, it does not matter where the payees or beneficiaries live. In the case of structured settlement annuity payees, resident payees are covered regardless of the residency of the contract owner.

Change of Residency: The guaranty association of the state in which the policy owner lives at the time the company becomes insolvent provides protection. Although all 50 states plus the District of Columbia and Puerto Rico have Guarantee Associations, the amount of protection may vary. If you move to another state, you should contact the Department of Insurance or guaranty association in that state for more information.

Conversely, The Guarantee Association only protects policies issued by an insurance company licensed to do business in California. An individual may, however, be entitled to receive protection from the guaranty association located in the insolvent company's state of domicile. One should contact the Department of Insurance or guaranty association in that state for more information.

Proscriptions against agents or companies extolling the virtues of Guarantee Association as a backstop: Insurers and agents are prohibited by state law from using the existence of the Guarantee Association to sell, solicit or induce the purchase of any form of insurance. This is because the protection is limited, and in some cases there is no protection at all. The existence of the Guarantee Association, therefore, is not and should not be a substitute for a consumer's prudent selection of an insurance company that is well managed and financially stable.

Attachment I Annuity Legislative History – Provider Reference

Understanding of the following annuity legislation is significant. It provides the evolutionary changes for each law throughout the years. It is important to know what impact the following pieces of legislation have had on annuity insurance. To review or obtain copies of the following pieces of legislation, you may log onto the California Legislature's Web site at http://www.leginfo.ca.gov or you may call the Legislative Bill Room at (916) 445-2645 to order copies of this legislation.

Year: 2003

SB 620, 2003, (Scott, Chapter 547), Annuities: life insurance: required disclosures and prohibited sales practices.
An act to amend Sections 787, 1725.5, 10127.10, and 10509.8 of, and to add Sections 789.9, 789.10, 1724, and 1749.8 to, the Insurance Code, relating to insurance.

- Enacts additional restrictions on advertising practices that target senior citizens and would expand the scope of existing restrictions, currently applicable to disability insurance, to life insurance and annuities.
- Prohibits the sale of annuities to seniors in certain circumstances.
- Prohibits insurance agents, brokers, and solicitors who are not attorneys from sharing commissions or other compensation with attorneys.
- Requires, effective January 1, 2005, specific training for life agents in order for these producers to sell annuities, unless the agents are nonresident agents who represent a direct response provider, as defined.
- Limits the investment of premiums during the 30-day cancellation period, except as specified, and revises the disclosure requirements applicable to the sale of life insurance and annuity products to seniors.
- Imposes restrictions on the sale of life insurance policies and annuities in the home of a senior citizen.
- Prohibits an agent or insurer from recommending the unnecessary replacement, as defined, of an annuity by a senior citizen.
- Imposes certain duties on the Insurance Commissioner in this regard, and enacts other related provisions.

SB 618, (Scott, Chapter 546), Insurance: unfair acts: licenses.
An act to amend Sections 782, 786, 789.3, and 10509.9 of, and to add Sections 1668.1 and 1738.5 to, the Insurance Code, relating to unfair acts.

- Raises the fine for a violation of these provisions to $1,500.
- Extends to individuals age 65 or older who purchase life insurance the protections described above that apply to those individuals who purchase disability policies.
- Declares that it applies to the purchase of life insurance only to the extent that

it does not conflict with the provisions of law regarding cancellation of life insurance policies and annuities.
- Increases the amounts of these monetary penalties, as specified.
- Provides that, if the commissioner brings an action against a licensee under these provisions and determines that the licensee may reasonably be expected to cause significant harm to seniors, the commissioner may suspend the license pending the outcome of the action. It allows the commissioner to require the rescission of any contract marketed, offered, or issued in violation of these provisions.
- Authorizes the commissioner to suspend or revoke any permanent license issued if the licensee induces the client to make a loan or gift to or investment with the licensee, or to otherwise act in other specified ways that benefit the licensee or other people acquainted with or related to the licensee.
- Requires that, if a disciplinary hearing of this type involves allegations of misconduct directed against a person age 65 or over, the hearing be held within 90 days after the Department of Insurance receives the notice of defense, unless a continuance is granted.
- Sets forth the grounds for granting a continuance, and provides that the burden of proof in a hearing shall be by a preponderance of the evidence.
- Increases the amounts of these monetary penalties, as specified, and allows the commissioner to suspend or revoke the license of any person who violates these provisions.

AB 284 (Chavez, Chapter 381), Deferred annuities: nonforfeiture
An act to amend Sections 10168.1 and 10168.2 of, and to add Sections 10168.25 and 10168.92 to, the Insurance Code, relating to annuities.
- Requires that these annuity contracts also provide that the company shall grant the paid-up annuity benefit upon the written request of the contract owner.
- Eliminates the requirement applicable to certain contracts that a company reserve the right to defer the payment of the cash surrender benefit for a period of 6 months, and instead allows the company to reserve that right after making written request and receiving written approval of the commissioner, as specified.
- Allows payment of the cash surrender benefit to be deferred for a period not to exceed 6 months.
- Provides for a uniform method of calculating minimum nonforfeiture amounts under these contracts. It modifies the interest rate applicable to accumulations under these contracts, the amounts by which those accumulations may be decreased, and the minimum amount of considerations used to determine the minimum nonforfeiture amount, as specified.
- Provides that these provisions shall apply to contracts issued on and after January 1, 2006, but that a company may elect to apply them, on a contract-form-by-contract-form basis, to any contract issued on or after January 1, 2004, and before January 1, 2006.
- Allows the Insurance Commissioner to adopt regulations to implement these provisions and to adjust the calculation of minimum nonforfeiture amounts for certain other contracts.

Year: 2002

AB 2984 (Committee on Insurance, Chapter 203), Insurance: depository institutions: production agencies: surplus line brokers: reinsurance intermediaries.

An act to amend Sections 1628, 1637, 1639, 1656, 1662, 1679, 1704, 1750.5, 1765.2, 1767, 1768, 1781.3, and 10234.93 of, to add Sections 1638.5 and 1639.1 to, to add Article 5.2 (commencing with Section 759) to Chapter 1 of Part 2 of Division 1 of, and to repeal Sections 1647, 1648, 1649, 1659, and 1714 of, the Insurance Code, relating to insurance.

- Establishes provisions regulating retail sales practices, solicitations, advertising, and offers of any insurance product or annuity to a consumer by a depository institution, or any person engaged in those activities at the office of a depository institution or on behalf of a depository institution.
- Revises licensing provisions with regard to production agencies, surplus line brokers, and reinsurance intermediaries, and also revises requirements for certain licensees within those categories. Because this bill expands the duties of a surplus line broker and thereby expand the definitions of crimes associated with a violation of these duties, the bill imposes a state-mandated local program.
- Provides that no reimbursement is required by this act for a specified reason.

Year: 2000

SB 423 (Johnston, Chapter 694), Life insurance: guaranteed living benefits

An act to add Section 10506.5 to the Insurance Code, relating to insurance, and declaring the urgency thereof, to take effect immediately.

- Authorizes a life insurer to deliver or issue for delivery variable contracts or riders to variable contracts containing guaranteed living benefits, as defined, under certain conditions.

AB 2107 (Scott, Chapter 442), Elder Abuse

An act to add Section 6177 to the Business and Professions Code, and to amend and renumber Section 10193 of, to amend Section 10234.8 of, and to add Section 789.8 to, the Insurance Code, and to amend Section 15610.30 of the Welfare and Institutions Code, relating to elder abuse.

- Imposes the duty of honesty, good faith, and fair dealing on insurers, brokers, agents, and others engaged in the business of Medicare supplemental insurance and long-term care insurance with respect to prospective policyholders.
- <u>Only permits life agents, on or after July 1, 2001, to sell or offer for sale to an elder or his or her agent any financial product on the basis of the product's treatment under Medi-Cal after providing the elder or his or her agent with a specified disclosure, in writing, explaining the resource and income requirements of the Medi-Cal program, including, but not limited to, certain exempt resources, certain protections against spousal impoverishment, and certain circumstances under which an interest in a home may be transferred without affecting Medi-Cal eligibility. The bill excludes from the application of these disclosure provisions credit life insurance, as defined.</u>
- Requires the State Bar to make a report, by December 31 of each year, to the

Legislature on the provision of financial services by lawyers to elders, as specified. The report would include the number of complaints filed and investigations initiated, the type of charges made, and the number and nature of disciplinary actions taken by the State Bar.

- Revises the definition of existing law that defines financial abuse for the purpose of reporting and investigating elder and dependent adult abuse.

Year: 1998

SB 1718 (Calderon, Chapter 386), Life insurance.

An act to amend Sections 10509.6 and 10541 of the Insurance Code, relating to life insurance.

- Existing law provides that every life insurer that uses an agent shall, among other things, when a replacement of insurance is involved, provide a notice delivered with the policy that the applicant has a right to an unconditional refund of all premiums, which right may be exercised within 20 days of the date of delivery of the policy. Existing law contains other provisions applicable to variable annuity contracts, variable life insurance contracts, and modified guaranteed contracts that authorize the return of the contract during the cancellation period. This bill adds the latter provision to the previous provisions requiring the applicant to be given notice of a right to an unconditional refund, and changes the 20-day period for the exercise of the right to obtain a refund to a 30-day period.
- Existing law permits certain insurers to issue funding agreements and provides that this authorization does not affect the priority of claims against insolvent insurers. This bill corrects a cross-reference relating to this priority of claims.

Year: 1997

SB 203 (Lewis, Chapter 28), Insurers: mortality tables.

An act to amend Sections 10163.2, 10489.2, and 10489.3 of the Insurance Code, relating to insurance.

- Existing law regulates the types of benefits to be paid under a policy of life insurance in the event of a default in premium payments or upon surrender of the policy, and also regulates the manner in which reserves are to be maintained by insurers issuing life insurance policies and annuity and pure endowment contracts.
- Existing law provides for insurers to use certain mortality tables for these purposes that have been approved by the Insurance Commissioner through promulgation of a regulation. This bill alternatively allows the commissioner to approve mortality tables through issuance of a bulletin.

Year: 1994

SB 1505 (Calderon, Chapter 984), Life insurance and annuity contracts: senior citizen policies and annuities

An act to amend Sections 10127.10, 10127.11, 10127.12, 10127.13, and 10506.3 of the Insurance Code, relating to life insurance, and declaring the urgency thereof, to take effect immediately.

- Makes specified changes in the cancellation procedures and notice requirements and, in addition, applies those procedures and requirements to individual annuity contracts. In addition, for variable annuity contracts, variable life insurance contracts, and modified guaranteed contracts, a cancelling purchaser would be entitled to a refund of any policy fee paid as well as payment for the value of the account. These provisions do not apply to specified types of group life insurance or group annuity contracts. Under specified circumstances, senior citizens are entitled to refunds if they cancel policies of group term life insurance during the first 30 days of the policy period. The bill also makes conforming changes.
- Also adds the options of stating only the location in the policy text of the required information in 12-point bold type on the cover page of the policy, or by disclosing that information on a sticker that is affixed to the cover page of the policy or to the policy jacket.
- Provides that modified guaranteed annuities are subject to the forfeiture provisions for individual deferred annuities computed under the terms of the annuity, but excluding market adjustment factors, as specified. In addition, group annuities exempted from the provisions governing individual deferred annuities are also exempted from any modified guaranteed annuity regulations.
- This exemption is retroactive to January 1, 1987, to the extent that the assets underlying the group contracts have not been maintained in a separate account. The bill provides that it is to take effect immediately as an urgency statute.

AB 1667 (Hoge, Chapter 6), California Insurance Guarantee Association
An act to amend Sections 1063, 1063.1, 1063.2, 1063.4, 1063.5, 1063.7, 1067.04, 1067.05, and 10112.5 of, to add Section 1067.055 to, and to repeal and add Section 1063.3 of, the
Insurance Code, relating to insurance, and declaring the urgency thereof, to take effect immediately.

- Existing law establishes a California Insurance Guarantee Association and specifies those insurers that are required to be members of the association. It exempts certain classes of insurance from assessments and other requirements of the association. This bill specifically enumerates those exempt classes of insurance, and provides that any insurer admitted to transact only those classes or kinds of insurance excluded from specified provisions shall not be a member of the association.
- Existing law provides that the association shall be managed by a board of governors serving for 3 year terms. Those terms expire each year. This bill provides that those terms expire each year on December 31.
- This bill also, among other things, does all of the following with respect to the California Insurance Guarantee Association: (a) Revises the definition of "insolvent insurer," and "covered claims," and defines "ocean marine insurance," as specified. (b) Revises certain policy construction and cancellation provisions with respect to insurer insolvency. (c) Revises the authorization of the association to submit reports and make recommendations to the Insurance Commissioner regarding the financial condition of member insurers, and certain examination and other report requirements, as specified.

(d) Revises insolvency premium provisions, as specified. (e) Specifies certain notice provisions with respect to an ancillary liquidator.

- Existing law provides for the California Life and Health Insurance Guarantee Association. The statute that established that association abolished the California Life Insurance Guaranty Association and the Robbins-Seastrand Health Insurance Guaranty Association. This bill provides that the California Life and Health Insurance Guarantee Association is created by the merger of the Robbins-Seastrand Health Insurance Guaranty Association with and into the California Life Insurance Guaranty Association and that the association succeeds to the rights, property, and obligations of the predecessors, as specified.
- Revises provisions dealing with the applicability of specified disability insurance policies issued outside of California to an employer whose principle place of business and majority of employees are located outside of California.

Year: 1993

SB 1065 (Mello, Chapter 516), Life insurance.
An act to add Sections 10127.10, 10127.11, 10127.12, and 10127.13 to the Insurance Code, relating to insurance.

- Adds additional provisions which permit a senior citizen, as defined, to cancel any policy of life insurance within 30 days following delivery, as specified. It requires those policies to contain a notice of that provision. Those provisions are inapplicable to individual life insurance policies issued in connection with a credit transaction or issued under a contractual policy change or conversion privilege provisions contained in a policy.
- Additionally makes those provisions inapplicable to noncontributory employer group life insurance contracts.
- Requires offerings of life insurance policies to senior citizens that contain illustrations of nonguaranteed values to contain certain disclosures. It requires annual statements to senior citizen policyowners to disclose the current accumulation value and current cash surrender value and requires life insurance policies for senior citizens, which contain a surrender charge period to disclose the surrender period and penalties associated therewith.

Attachment II Life Agent Disclosure Requirements for Sales to Elders

Assembly Bill 2107

Effective July 1, 2001, Chapter 442, Statutes of 2000 (Assembly Bill 2107, Scott), strengthens the Elder Abuse and Dependent Civil Protection Act with respect to selling insurance and financial products to elders and clarifies the definition of financial abuse. (The definition of "elders" is any person residing in this state that is 65 years of age or older.)

At the time of the enactment of this law, a life agent is required to make specified disclosures about the potential consequences of entering into financial transactions related to an elder's potential eligibility for Medi-Cal coverage and prohibits a life agent from negligently misrepresenting a product based on its treatment under Medi-Cal.

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Required Medi-Cal Disclosure

A life agent who offers for sale or sells any financial product on the basis of its treatment under the Medi-Cal program shall provide, in writing, the following disclosure to the elder or the elder's agent:

NOTICE REGARDING STANDARDS FOR MEDI-CAL ELIGIBILITY

If you or your spouse is considering purchasing a financial product based on its treatment under the Medi-Cal program, read this important message!

You or your spouse does not have to use up all of your savings before applying for Medi-Cal.

UNMARRIED RESIDENT

An unmarried resident may be eligible for Medi-Cal benefits if he or she has less than $2,000 in countable resources.

The Medi-Cal recipient is allowed to keep from his or her monthly income a personal allowance of $35 plus the amount of any health insurance premiums paid. The remainder of the monthly income is paid to the nursing facility as a monthly share of cost.

MARRIED RESIDENT

COMMUNITY SPOUSE RESOURCE ALLOWANCE: If one spouse lives in a nursing facility, and the other spouse does not live in a facility, the Medi-Cal program will pay some or all of the nursing facility costs as long as the couple together does not have more than $123,600 + $2,000 (for 2018).

MINIMUM MONTHLY MAINTENANCE NEEDS ALLOWANCE: If a spouse is eligible for Medi-Cal payment of nursing facility costs, the spouse living at home is allowed to keep a monthly income of at least his or her individual monthly income or $3,090 (for 2018), whichever is greater.

FAIR HEARINGS AND COURT ORDERS

Under certain circumstances, an at-home spouse can obtain an order from an administrative law judge or court that will allow the at-home spouse to retain additional resources or income. The order may allow the couple to retain more than $123,600 + $3,090 (for 2018) in countable resources. The order also may allow the at-home spouse to retain more than $3,090 (for 2018) in monthly income.

REAL AND PERSONAL PROPERTY EXEMPTIONS

Many of your assets may already be exempt. Exempt means that the assets are not counted when determining eligibility for Medi-Cal.

REAL PROPERTY EXEMPTIONS

ONE PRINCIPAL RESIDENCE. One property used as a home is exempt. The home will remain exempt in determining eligibility if the applicant intends to return home someday.

The home also continues to be exempt if the applicant’s spouse or dependent relative continues to live in it.

Money received from the sale of a home can be exempt for up to six months if the money is going to be used for the purchase of another home.

REAL PROPERTY USED IN A BUSINESS OR TRADE. Real estate used in a trade or business is exempt regardless of its equity value and whether it produces income.

PERSONAL PROPERTY AND OTHER EXEMPT ASSETS

IRAs, KEOGHs, AND OTHER WORK-RELATED PENSION PLANS. These funds are exempt if the family member whose name it is in does not want Medi-Cal. If held in the name of a person who wants Medi-Cal and payments of principal and interest are being received, the balance is considered unavailable and is not counted. It is not necessary to annuitize, convert to an annuity, or otherwise change the form of the assets in order for them to be unavailable.

PERSONAL PROPERTY USED IN A TRADE OR BUSINESS

ONE MOTOR VEHICLE

IRREVOCABLE BURIAL TRUSTS OR IRREVOCABLE PREPAID BURIAL CONTRACTS.

THERE MAY BE OTHER ASSETS THAT MAY BE EXEMPT.

This is only a brief description of the Medi-Cal eligibility rules, for more detailed information, you should call your county welfare department. Also, you are advised to contact a legal services program for seniors or an attorney that is not connected with the sale of this product.

I have read the above notice and have received a copy.

Dated:____

Signature: ____

Signature: ____

The statement required in this subdivision shall be printed in at least 12-point type, shall be clearly separate from any other document or writing, and shall be signed by the prospective purchaser and that person's spouse, and legal representative, if any.

The State Department of Health Services (http://www.dhs.ca.gov/mcs/default.htm) shall update this form to ensure consistency with state and federal law and make the disclosure available to agents and brokers through its Internet Web site.

Life Agent's Duties

Pursuant to Section 10193 of the California Insurance Code, with regard to Medicare supplement insurance and long-term care insurance, all insurers, brokers, agents, and others engaged in the business of insurance owe a policyholder or a prospective policyholder a duty of honesty, and a duty of good faith and fair dealing.

Conduct of an insurer, broker, or agent during the offer and sale of a policy previous to the purchase is relevant to any action alleging a breach of the duty of honesty, and a duty of good faith and fair dealing.

Elder Abuse

Pursuant to Section 15610.30 of the California Welfare & Institutions Code:

(a) "Financial abuse" of an elder or dependent adult occurs when a person or entity does any of the following:

(1) Takes, secretes, appropriates, or retains real or personal property of an elder or dependent adult to a wrongful use or with intent to defraud, or both.
(2) Assists in taking, secreting, appropriating, or retaining real or personal property of an elder or dependent adult to a wrongful use or with intent to defraud, or both.

(b) A person or entity shall be deemed to have taken, secreted, appropriated, or retained property for a wrongful use if, among other things, the person or entity takes, secretes, appropriates or retains possession of property in bad faith.

(1) A person or entity shall be deemed to have acted in bad faith if the person or entity knew or should have known that the elder or dependent adult had the right to have the property transferred or made readily available to the elder or dependent adult or to his or her representative.

(2) For purposes of this section, a person or entity should have known of a right specified in paragraph (1) if, on the basis of the information received by the person or entity or the person or entity's authorized third party, or both, it is obvious to a reasonable person that the elder or dependent adult has a right specified in paragraph (1).

Life Agent Financial Products Disclosure

Pursuant to Section 789.8 of the California Insurance Code, if a life agent offers to sell to an elder any life insurance or annuity product, the life agent shall advise an elder or elder's agent in writing that the sale or liquidation of any stock, bond, IRA, certificate of deposit, mutual fund, annuity, or other asset to fund the purchase of this product may have tax consequences, early withdrawal penalties, or other costs or penalties as a result of the sale or liquidation, and that the elder or elder's agent may wish to consult independent legal or financial advice before selling or liquidating any assets and prior to the purchase of any life or annuity products being solicited, offered for sale, or sold. This section does not apply to a credit life insurance product.

A life agent who offers for sale or sells a financial product to an elder on the basis of the product's treatment under the Medi-Cal program may not negligently misrepresent the treatment of any asset under the rules and regulations of the Medi-Cal program, as it pertains to the determination of the elder's eligibility for any program of public assistance.

A life agent who offers for sale or sells any financial product on the basis of its treatment under the Medi-Cal Program shall provide, in writing, the required disclosure.

BILL NUMBER: AB 2107 CHAPTERED
BILL TEXT

CHAPTER 442
FILED WITH SECRETARY OF STATE SEPTEMBER 14, 2000
APPROVED BY GOVERNOR SEPTEMBER 13, 2000
PASSED THE ASSEMBLY AUGUST 29, 2000
PASSED THE SENATE AUGUST 28, 2000
AMENDED IN SENATE AUGUST 24, 2000
AMENDED IN SENATE AUGUST 18, 2000
AMENDED IN SENATE AUGUST 7, 2000
AMENDED IN ASSEMBLY MAY 31, 2000
AMENDED IN ASSEMBLY MAY 16, 2000
AMENDED IN ASSEMBLY APRIL 24, 2000
AMENDED IN ASSEMBLY APRIL 3, 2000

INTRODUCED BY Assembly Member Scott
(Coauthor: Assembly Member Jackson)

FEBRUARY 22, 2000

An act to add Section 6177 to the Business and Professions Code, and to amend and renumber Section 10193 of, to amend Section 10234.8 of, and to add Section 789.8 to, the Insurance Code, and to amend Section 15610.30 of the Welfare and Institutions Code, relating to elder abuse.

LEGISLATIVE COUNSEL'S DIGEST

AB 2107, Scott. Elder abuse.

(1) Existing law imposes on all insurers, brokers, agents, and others engaged in the business of Medicare supplemental insurance and long-term care insurance with a policyholder, a duty of honesty, good faith, and fair dealing.

This bill would impose the duty of honesty, good faith, and fair dealing on insurers, brokers, agents, and others engaged in the business of Medicare supplemental insurance and long-term care insurance with respect to prospective policyholders.

The bill would only permit life agents, on or after July 1, 2001, to sell or offer for sale to an elder or his or her agent any financial product on the basis of the product's treatment under Medi-Cal after providing the elder or his or her agent with a specified disclosure, in writing, explaining the resource and income requirements of the Medi-Cal program, including, but not limited to, certain exempt resources, certain protections against spousal impoverishment, and certain circumstances under which an interest in a home may be transferred without affecting Medi-Cal eligibility.

The bill would exclude from the application of these disclosure provisions credit life insurance, as defined.

(2) Existing law prohibits conflicts of interest between an attorney and client.
This bill would require the State Bar to make a report, by December 31 of each year, to the Legislature on the provision of financial services by lawyers to elders, as specified. The report would include the number of complaints filed and investigations initiated, the type of charges made, and the number and nature of disciplinary actions taken by the State Bar.

(3) Existing law defines financial abuse for the purpose of reporting and investigating elder and dependent adult abuse. This bill would revise that definition.

THE PEOPLE OF THE STATE OF CALIFORNIA DO ENACT AS FOLLOWS:

SECTION 1. Section 6177 is added to the Business and Professions Code, to read:

6177. The State Bar by December 31 of each year shall report to the Legislature on the number of complaints filed against California attorneys alleging a violation of this article. The report shall also include the type of charges made in each complaint, the number of resulting investigations initiated, and the number and nature of any disciplinary actions taken by the State Bar for violations of this article.

SEC. 2. Section 789.8 is added to the Insurance Code, to read:

789.8. (a) "Elder" for purposes of this section means any person residing in this state, 65 years of age or older.

(b) If a life agent offers to sell to an elder any life insurance or annuity product, the life agent shall advise an elder or elder's agent in writing that the sale or liquidation of any stock, bond, IRA, certificate of deposit, mutual fund, annuity, or other asset to fund the purchase of this product may have tax consequences, early withdrawal penalties, or other costs or penalties as a result of the sale or liquidation, and that the elder or elder's agent may wish to consult independent legal or financial advice before selling or liquidating any assets and prior to the purchase of any life or annuity products being solicited, offered for sale, or sold. This section does not apply to a credit life insurance product as defined in Section 779.2.

(c) A life agent who offers for sale or sells a financial product to an elder on the basis of the product's treatment under the Medi-Cal program may not negligently misrepresent the treatment of any asset under the statutes and rules and regulations of the Medi-Cal program, as it pertains to the determination of the elder's eligibility for any program of public assistance.

(d) A life agent who offers for sale or sells any financial product on the basis of its treatment under the Medi-Cal program shall provide, in writing, the following disclosure to the elder or the elder's agent:

"NOTICE REGARDING STANDARDS FOR MEDI-CAL ELIGIBILITY

If you or your spouse are considering purchasing a financial product based on its treatment under the Medi-Cal program, read this important message!

You or your spouse do not have to use up all of your savings before applying for Medi-Cal.

UNMARRIED RESIDENT

An unmarried resident may be eligible for Medi-Cal benefits if he or she has less than (insert amount of individual's resource allowance) in countable resources.

The Medi-Cal recipient is allowed to keep from his or her monthly income a personal allowance of (insert amount of personal needs allowance) plus the amount of any health insurance premiums paid. The remainder of the monthly income is paid to the nursing facility as a monthly share of cost.

MARRIED RESIDENT

COMMUNITY SPOUSE RESOURCE ALLOWANCE: If one spouse lives in a nursing facility, and the other spouse does not live in a facility, the Medi-Cal program will pay some or all of the nursing facility costs as long as the couple together does not have more than (insert amount of community countable assets).

MINIMUM MONTHLY MAINTENANCE NEEDS ALLOWANCE: If a spouse is eligible for Medi-Cal payment of nursing facility costs, the spouse living at home is allowed to keep a monthly income of at least his or her individual monthly income or (insert amount of the minimum monthly maintenance needs allowance), whichever is greater.

FAIR HEARINGS AND COURT ORDERS

Under certain circumstances, an at-home spouse can obtain an order from an administrative law judge or court that will allow the at-home spouse to retain additional resources or income. The order may allow the couple to retain more than (insert amount of community spouse resource allowance plus individual's resource allowance) in countable resources. The order also may allow the at-home spouse to retain more than (insert amount of the monthly maintenance need allowance) in monthly income.

REAL AND PERSONAL PROPERTY EXEMPTIONS

Many of your assets may already be exempt. Exempt means that the assets are not counted when determining eligibility for Medi-Cal.

REAL PROPERTY EXEMPTIONS

ONE PRINCIPAL RESIDENCE. One property used as a home is exempt. The home will remain exempt in determining eligibility if the applicant intends to return home someday.

The home also continues to be exempt if the applicant's spouse or dependent relative continues to live in it.

Money received from the sale of a home can be exempt for up to six months if the money is going to be used for the purchase of another home.

REAL PROPERTY USED IN A BUSINESS OR TRADE. Real estate used in a trade or business is exempt regardless of its equity value and whether it produces income.

PERSONAL PROPERTY AND OTHER EXEMPT ASSETS

IRAs, KEOGHs, AND OTHER WORK-RELATED PENSION PLANS. These funds are exempt if the family member whose name it is in does not want Medi-Cal. If held in the name of a person who wants Medi-Cal and payments of principal and interest are being received, the balance is considered unavailable and is not counted. It is not necessary to annuitize, convert to an annuity, or otherwise change the form of the assets in order for them to be unavailable.

PERSONAL PROPERTY USED IN A TRADE OR BUSINESS.

ONE MOTOR VEHICLE.

IRREVOCABLE BURIAL TRUSTS OR IRREVOCABLE PREPAID BURIAL CONTRACTS.

THERE MAY BE OTHER ASSETS THAT MAY BE EXEMPT.

This is only a brief description of the Medi-Cal eligibility rules, for more detailed information, you should call your county welfare department. Also, you are advised to contact a legal services program for seniors or an attorney that is not connected with the sale of this product.

I have read the above notice and have received a copy. Dated: ________________ Signature: _________________"

The statement required in this subdivision shall be printed in at least 12-point type, shall be clearly separate from any other document or writing, and shall be signed by the prospective purchaser and that person's spouse, and legal representative, if any.

(e) The State Department of Health Services shall update this form to ensure consistency with state and federal law and make the disclosure available to agents and brokers through its Internet website.

(f) Nothing in this section allows or is intended to allow the unlawful practice of law.

(g) Subdivisions (b) and (d) shall become operative on July 1, 2001.

SEC. 3. Section 10193 of the Insurance Code is amended and renumbered to read:

10192.55. (a) With regard to Medicare supplement insurance, all insurers, brokers, agents, and others engaged in the business of insurance owe a policyholder or a prospective policyholder a duty of honesty, and a duty of good faith and fair dealing.

(b) Conduct of an insurer, broker, or agent during the offer and sale of a policy previous to the purchase is relevant to any action alleging a breach of the duty of honesty, and a duty of good faith and fair dealing.

SEC. 4. Section 10234.8 of the Insurance Code is amended to read:

10234.8. (a) With regard to long-term care insurance, all insurers, brokers, agents, and others engaged in the business of insurance owe a policyholder or a prospective policyholder a duty of honesty, and a duty of good faith and fair dealing.

(b) Conduct of an insurer, broker, or agent during the offer and sale of a policy previous to the purchase is relevant to any action alleging a breach of the duty of honesty, and a duty of good faith and fair dealing.

SEC. 5. Section 15610.30 of the Welfare and Institutions Code is amended to read:

15610.30. (a) "Financial abuse" of an elder or dependent adult occurs when a person or entity does any of the following:

(1) Takes, secretes, appropriates, or retains real or personal property of an elder or dependent adult to a wrongful use or with intent to defraud, or both.

(2) Assists in taking, secreting, appropriating, or retaining real or personal property of an elder or dependent adult to a wrongful use or with intent to defraud, or both.

(b) A person or entity shall be deemed to have taken, secreted, appropriated, or retained property for a wrongful use if, among other things, the person or entity takes, secretes, appropriates or retains possession of property in bad faith.

(1) A person or entity shall be deemed to have acted in bad faith if the person or entity knew or should have known that the elder or dependent adult had the right to have the property transferred or made readily available to the elder or dependent adult or to his or her representative.

(2) For purposes of this section, a person or entity should have known of a right specified in paragraph (1) if, on the basis of the information received by the person or entity or the person or entity’s authorized third party, or both, it is obvious to a reasonable person that the elder or dependent adult has a right specified in paragraph (1).

(c) For purposes of this section, "representative" means a person or entity that is either of the following:

(1) A conservator, trustee, or other representative of the estate of an elder or dependent adult.

(2) An attorney-in-fact of an elder or dependent adult who acts within the authority of the power of attorney.

(SAMPLE FROM INSURER)

TITLE: ______________________________

To: ____
Prospective California Client *(please print)*

From: ____
Agent *(please print)*

Pursuant to California Insurance regulation, I am required to advise you of the following:

In the event I recommend that you sell or liquidate any stocks, bonds, IRA, certificate of deposit, mutual fund annuity, or other assets to fund the purchase of an annuity from an insurance company, you may be subject to some or all of the following:

1. Tax consequences;
2. Early withdrawal penalties;
3. Or, other costs or penalties.

You may wish to consult an independent legal or financial advisor before selling or liquidating any assets and prior to purchasing an annuity.
I acknowledge receipt of this disclosure and understand its contents.

____
Signature of Prospective California Client Date

____
Signature of Agent Date

(SAMPLE FROM INSURER)

NOTICE REGARDING STANDARDS FOR MEDI-CAL ELIGIBILITY

If you or your spouse is considering purchasing a financial product based on its treatment under the Medi-Cal program, read this important message!

You or your spouse does not have to use up all of your savings before applying for Medi-Cal.

UNMARRIED RESIDENT

An unmarried resident may be eligible for Medi-Cal benefits if he or she has less than $2,000 in countable resources.

The Medi-Cal recipient is allowed to keep from his or her monthly income a personal allowance of $35 plus the amount of any health insurance premiums paid. The remainder of the monthly income is paid to the nursing facility as a monthly share of cost.

MARRIED RESIDENT

COMMUNITY SPOUSE RESOURCE ALLOWANCE: If one spouse lives in a nursing facility, and the other spouse does not live in a facility, the Medi-Cal program will pay some or all of the nursing facility costs as long as the couple together does not have more than $123,600 + $3,090 (for 2018).

MINIMUM MONTHLY MAINTENANCE NEEDS ALLOWANCE: If a spouse is eligible for Medi-Cal payment of nursing facility costs, the spouse living at home is allowed to keep a monthly income of at least his or her individual monthly income or $2319 (for 2004), whichever is greater.

FAIR HEARINGS AND COURT ORDERS

Under certain circumstances, an at-home spouse can obtain an order from an administrative law judge or court that will allow the at-home spouse to retain additional resources or income. The order may allow the couple to retain more than $123,600 + $3,090 (for 2018) in countable resources. The order also may allow the at-home spouse to retain more than $3,090 (for 2004) in monthly income.

REAL AND PERSONAL PROPERTY EXEMPTIONS

Many of your assets may already be exempt. Exempt means that the assets are not counted when determining eligibility for Medi-Cal.

REAL PROPERTY EXEMPTIONS

ONE PRINCIPAL RESIDENCE. One property used as a home is exempt. The home will remain exempt in determining eligibility if the applicant intends to return home someday.

The home also continues to be exempt if the applicant's spouse or dependent relative continues to live in it.

Money received from the sale of a home can be exempt for up to six months if the money is going to be used for the purchase of another home.

REAL PROPERTY USED IN A BUSINESS OR TRADE. Real estate used in a trade or business is exempt regardless of its equity value and whether it produces income.

PERSONAL PROPERTY AND OTHER EXEMPT ASSETS

IRAs, KEOGHs, AND OTHER WORK-RELATED PENSION PLANS. These funds are exempt if the family member whose name it is in does not want Medi-Cal. If held in the name of a person who wants Medi-Cal and payments of principal and interest are being received, the balance is considered unavailable and is not counted. It is not necessary to annuitize, convert to an annuity, or otherwise change the form of the assets in order for them to be unavailable.

PERSONAL PROPERTY USED IN A TRADE OR BUSINESS

ONE MOTOR VEHICLE

IRREVOCABLE BURIAL TRUSTS OR IRREVOCABLE PREPAID BURIAL CONTRACTS.

THERE MAY BE OTHER ASSETS THAT MAY BE EXEMPTING.

This is only a brief description of the Medi-Cal eligibility rules, for more detailed information, you should call your county welfare department. Also, you are advised to contact a legal services program for seniors or an attorney that is not connected with the sale of this product.

I have read the above notice and have received a copy.

Dated:____

Signature: ____

Signature: ____

Attachment III Penalties

Penalties Defined (Section 782, 786, 789.3, 1738.5, 10509.910 et seq. of the CIC)

California Insurance Code	Violation	Penalty
Section 782 Establishes penalties for violation of section 780 and section 781	**Section 780** - Prohibited Misrepresentation **Section 781** - Twisting (see page 3 for actual language)	Punishable by fine not to exceed $25,000, or if victim loss exceeds $10,000, the fine not to exceed 3 times the loss suffered by the victim, by imprisonment not to exceed 1 year or by both a fine and imprisonment Restitution to victim pursuant to Section 1202.4 of the Penal Code shall be satisfied before any fine imposed by this section is collected
Section 786 Provides for an examination period of 30 days after the receipt of the policy or certificate for purposes of review of the contract	no violations or penalties cited in this section (see page 3 for actual language)	
Section 789.3 Administrative penalties; amounts; rescission of contracts	**Section 789.3:** (a) and (b) by broker, agent, or other person engaged in the transactions of insurance other than an insurer (see page 4 for actual language) (d) and (e) by insurer	789.3(a) minimum $1,000 for the first violation 789.3(b) minimum $5,000 and no more than $50,000 each subsequent violation 789.3(c) Commissioner may suspend or revoke license 789.3(d) $10,000 for the first violation 789.3(e) minimum $30,000 and no more than $300,000 each violation thereafter 789.3(f) Commissioner may require rescission of contract

Section 1668.1 Acts that constitute cause to suspend re revoke any permanent license issued pursuant to this chapter	no violations or penalties cited in this section (see page 5 for actual language)	
Section 1738.5 A proceeding held pursuant to section 1668, 1668.5, 1738, 1739, or 12921.8	no violations or penalties cited in this section (see page 5 for actual language)	
Section 10509.9 Administrative penalties:	**Section 10509.9:** (a) and (b) by any agent or other person or entity engaged in the business of insurance other than an insurer (see page 6 for actual language) (c) and (d) by insurer (see page 6 for actual language) (e) by person or entity after a hearing (see page 6 for actual language)	10509.9 (a) $1,000 for the first violation 10509.9 (b) minimum $5,000 and no more than $50,000 each subsequent violation 10509.9 (c) $10,000 for the first violation 10509.9 (d) minimum $30,000 and no more than $300,000 each violation thereafter 10509.9 (e) the Commissioner may suspend or revoke the license
Section 10509.916 **Insurer responsibilities**	violations and penalties to be determined (see page 7 for actual language)	

Current Law

This list includes the statutes stated in SB 618 and the penalty statute from AB 689 (Chapter 295, Statutes of 2011) Insurance: annuity transactions, Section 10509.914 of the California Insurance Code, which took effect on January 1, 2012.

Section 780: An insurer or officer or agent thereof, or an insurance broker or solicitor shall not cause or permit to be issued, circulated or used, any statement that is known, or should have been known, to be a misrepresentation of the following:

(a) The terms of a policy issued by the insurer or sought to be negotiated by the person making or permitting the misrepresentation.
(b) The benefits or privileges promised there under.
(c) The future dividends payable there under.

Section 781: (a) A person shall not make any statement that is known, or should have been known, to be a misrepresentation (1) to any other person for the purpose of inducing, or tending to induce, such other person either to take out a policy of insurance, or to refuse to accept a policy issued upon an application therefore and instead take out any policy in another insurer, or (2) to a policyholder in any insurer for the purpose of inducing or tending to induce him or her to lapse, forfeit or surrender his or her insurance therein.
(b)A person shall not make any representation or comparison of insurers or policies to an insured which is misleading, for the purpose of inducing or tending to induce him or her to lapse, forfeit, change or surrender his or her insurance, whether on a temporary or permanent plan.

Section 782: Any person who violates the provisions of Section 780 or 781 is punishable by a fine not exceeding twenty-five thousand dollars ($25,000), or in a case in which the loss of the victim exceeds ten thousand dollars ($10,000), by a fine not exceeding three times the amount of the loss suffered by the victim, by imprisonment in a county jail for a period not to exceed one year, or by both a fine and imprisonment. Restitution to the victim ordered pursuant to Section 1202.4 of the Penal Code shall be satisfied before any fine imposed by this section is collected.

Section 786: All disability insurance and life insurance policies and certificates offered for sale to individuals age 65 or older in California shall provide an examination period of 30 days after the receipt of the policy or certificate for purposes of review of the contract, at which time the applicant may return the contract. The return shall void the policy or certificate from the beginning, and the parties shall be in the same position as if no contract had been issued. All premiums paid and any policy or membership fee shall be fully refunded to the applicant by the insurer or entity in a timely manner.

a) For the purposes of this section a timely manner shall be no later than 30 days after the insurer or entity issuing the policy or certificate receives the returned policy or certificate.

b) If the insurer or entity issuing the policy or certificate fails to refund all of the premiums paid, in a timely manner, then the applicant shall receive interest on the paid premium at the legal rate of interest on judgments as provided in Section 685.010 of the Code of Civil Procedure. The interest shall be paid from the date the insurer or entity received the returned policy or certificate.

(c) Each policy or certificate shall have a notice prominently printed in no less than 10-point uppercase type, on the cover page of the policy or certificate and the outline of coverage, stating that the applicant has the right to return the policy or certificate within 30 days after its receipt via regular mail, and to have the full premium refunded.

(d) In the event of any conflict between this section and Section 10127.10 with respect to life insurance, the provisions of Section 10127.10 shall prevail.

Section 789.3: (a) Any broker, agent, or other person or other entity engaged in the transactions of insurance, other than an insurer, who violates this article is liable for an administrative penalty of no less than one thousand dollars ($1,000) for the first violation.

(b) Any broker, agent, other person, or other entity engaged in the business of insurance, other than an insurer, who engages in practices prohibited by this article a second or subsequent time or who commits a knowing violation of this article, is liable for an administrative penalty of no less than five thousand dollars ($5,000) and no more than fifty thousand dollars ($50,000) for each violation.

(c) If the commissioner brings an action against a licensee pursuant to subdivision (a) or (b) and determines that the licensee may reasonably be expected to cause significant harm to seniors, the commissioner may suspend his or her license pending the outcome of the hearing described in subdivision (c) of Section 789.

(d) Any insurer who violates this article is liable for an administrative penalty of ten thousand dollars ($10,000) for the first violation.

(e) Any insurer who violates this article with a frequency as to indicate a general business practice or commits a knowing violation of this article, is liable for an administrative penalty of no less than thirty thousand dollars ($30,000) and no more than three hundred thousand dollars ($300,000) for each violation.

(f) The commissioner may require rescission of any contract found to have been marketed, offered, or issued in violation of this article.

Section 1668.1: (a) The licensee has induced a client, whether directly or indirectly, to cosign or make a loan, make an investment, make a gift, including a testamentary gift, or provide any future benefit through a right of survivorship to the licensee, or to any of the persons listed in subdivision (e).

(b) The licensee has induced a client, whether directly or indirectly, to make the licensee or any of the persons listed in subdivision (e) a beneficiary under the terms of any intervivos or testamentary trust or the owner or beneficiary of a life insurance policy or an annuity policy.

(c) The licensee has induced a client, whether directly or indirectly, to make the licensee, or a person who is registered as a domestic partner of the licensee, or is related to the licensee by birth, marriage, or adoption, a trustee under the terms of any intervivos or testamentary trust. However, if the licensee is also licensed as an attorney in any state, the licensee may be made a trustee under the terms of any intervivos or testamentary trust, provided that the licensee is not a seller of insurance to the trustor of the trust.

(d) The licensee, who has a power of attorney for a client has sold to the client or has used the power of attorney to purchase an insurance product on behalf of the client for which the licensee has received a commission.

(e) Subdivisions (a) and (b) shall also apply if the licensee induces the client to provide the benefits in those subdivisions to the following people:

(1) A person who is related to the licensee by birth, marriage, or adoption.
(2) A person who is a friend or business acquaintance of the licensee.
(3) A person who is registered as a domestic partner of the licensee.

(f) This section shall not apply to situations in which the client is:

(1) A person related to the licensee by birth, marriage, or adoption.
(2) A person who is registered as a domestic partner of the licensee.

Section 1738.5: A proceeding held pursuant to Section 1668, 1668.5, 1738, 1739, or 12921.8 that involves allegations of misconduct perpetrated against a person age 65 or over shall be held within 90 days after receipt by the department of the notice of defense, unless a continuance of the hearing is granted by the department or the administrative law judge. When the matter has been set for hearing, only the administrative law judge may grant a continuance of the hearing. The administrative law judge may, but need not, grant a continuance of the hearing, only upon finding the existence of one or more of the following:

(a) The death or incapacitating illness of a party, a representative or attorney of a party, a witness to an essential fact, or of the parent, child, or member of the household of any of these persons, when it is not feasible to substitute another representative, attorney, or witness because of the proximity of the hearing date.

(b) Lack of notice of hearing as provided in Section 11509 of the Government Code.

(c) A material change in the status of the case where a change in the parties or pleadings requires postponement, or an executed settlement or stipulated findings of fact obviate the need for hearing. A partial amendment of the pleadings shall not be good cause for continuance to the extent that the un-amended portion of the pleadings is ready to be heard.

(d) A stipulation for continuance signed by all parties, or their authorized representatives, that is communicated with the request for continuance to the administrative law judge no later than 25 business days before the hearing.

(e) The substitution of the representative or attorney of a party upon showing that the substitution is required.

(f) The unavailability of a party, representative, or attorney of a party, or witness to an essential fact, due to a conflicting and required appearance in a judicial matter if, when the hearing date was set, the person did not know and could neither anticipate nor at any time avoid the conflict, and the conflict, with the request for continuance, is immediately communicated to the administrative law judge.

(g) The unavailability of a party, a representative or attorney of a party, or a material witness due to an unavoidable emergency.

(h) Failure by a party to comply with a timely discovery request if the continuance request is made by the party who requested the discovery.

Section 10509.9: (a) Any agent or other person or entity engaged in the business of **insurance**, other than an insurer, who violates this article is liable for an administrative penalty of no less than one thousand dollars ($1,000) for the first violation.

(b) Any agent or other person or entity engaged in the business of insurance, other than an insurer, who engages in practices prohibited by this chapter a second or subsequent time or who commits a knowing violation of this article, is liable for an administrative penalty of no less than five thousand dollars ($5,000) and no more than fifty thousand dollars ($50,000) for each violation.

(c) Any insurer who violates this article is liable for an administrative penalty of ten thousand dollars ($10,000) for the first violation.

(d) Any insurer who violates this article with a frequency as to indicate a general business practice or commits a knowing violation of this article, is liable for an administrative penalty of no less than thirty thousand dollars ($30,000) and no more than three hundred thousand dollars ($300,000) for each violation.

(e) After a hearing conducted in accordance with Chapter 4.5 (commencing with Section 11400) and Chapter 5 (commencing with Section 11500) of Part 1 of Division 3 of Title 2 of the Government Code, the commissioner may suspend or revoke the license of any person or entity that violates this article.

(f) Nothing in this section shall be deemed to affect any other authority provided by law to the commissioner.

Section 10509.916: (a) An insurer is responsible for compliance with this article. If a violation occurs, either because of the action or inaction of the insurer or its insurance producer, the commissioner may, in addition to any other available penalties, remedies, or administrative actions, order any or all of the following:

(1) An insurer to take reasonably appropriate corrective action for any consumer harmed by the insurers, or by its insurance producer's, violation of this article.

(2) A managing general agent or an insurance producer to take reasonably appropriate corrective action for any consumer harmed by the insurance producer's violation of this article.

(3) Penalties and sanctions pursuant to Section 10509.9. For purposes of Section 10509.9, this article shall be deemed to be part of Article 8 (commencing with Section 10509), and the commissioner may in a single enforcement action seek penalties for a first and a second or subsequent violation.