Understanding Annuities

This guide:
Explains the different types of annuity contracts
Describes the various contractual features
Discusses how to shop for an annuity

State of Wisconsin
Office of the Commissioner of Insurance
P.O. Box 7873
Madison, WI 53707-7873

OCI's World Wide Web Home Page:
oci.wi.gov

PI-214 (R 11/2009)

The mission of the Office of
the Commissioner of Insurance . . .
Leading the way in informing and protecting
the public and responding to their insurance needs.

If you have a specific complaint about your insurance, refer it first to the insurance company or agent involved. If you do not receive satisfactory answers, contact the Office of the Commissioner of Insurance (OCI).

For information on how to file an insurance complaint call:
(608) 266-0103 (In Madison) or 1-800-236-8517 (Statewide)

Mailing Address
Office of the Commissioner of Insurance
P.O. Box 7873
Madison, WI 53707-7873

Electronic Mail
ocicomplaints@wisconsin.gov
Please indicate your name, phone number, and e-mail address.

OCI's World Wide Web Home Page
oci.wi.gov

For your convenience, a copy of OCI's complaint form is available at the back of this booklet. A copy of OCI's complaint form is also available on OCI's Web site.

A list of OCI's publications is included at the back of this booklet. Copies of OCI publications are also available online on OCI's Web site.

Deaf, hearing, or speech impaired callers may
reach OCI through WI TRS

This guide is not a legal analysis of your rights under any insurance policy or government program. Your insurance policy, program rules, Wisconsin law, federal law, and court decisions establish your rights. You may want to consult an attorney for legal guidance about your specific rights.

The Office of the Commissioner of Insurance does not represent that the information in this publication is complete, accurate or timely in all instances. All information is subject to change on a regular basis, without notice.

Printed copies of publications are updated annually unless otherwise stated. In an effort to provide more current information, publications available on OCI's Web site are updated more frequently than the hard copy versions to reflect any necessary changes. Visit OCI's Web site at **oci.wi.gov**.

Table of Contents

Introduction

To increase financial security in retirement, more and more people are including annuities in their financial planning. Because there are many different types of annuity contracts and a variety of annuity options available, it can be difficult to understand how they actually work.

Purpose of this guide

This booklet serves as a guide to help you understand annuities as a source of retirement income. When considering the purchase of an annuity, it is important to understand the different types of annuities, how annuities work, the contractual features of the policy, and the benefits, as well as risks, in order to choose the kind of annuity that would best fit your retirement needs.

Annuity contracts

Annuities are complex and cannot be fully discussed here. You may want to consult your accountant or financial planner when deciding if an annuity will meet your retirement needs. This guide should be used primarily to help you make choices when buying an individual deferred annuity.

What is an annuity?

Annuity contracts are sold by life insurance companies but annuities are not life insurance.

An annuity is a written contract between you and a life insurance company in which the insurance company makes a series of regularly spaced payments to you in return for a premium or premiums you have paid. But an annuity is not life insurance. A life insurance policy provides benefits to your family if you die. An annuity helps you accumulate money for future income needs. An annuity is not a savings account or savings certificate and it should not be bought for short-term purposes. The most appropriate use for income payments from an annuity contract is to fund your retirement.

The owner
The annuitant
The beneficiary

There are three participants in an annuity contract: the owner, the annuitant and the beneficiary. Most of the time the annuitant and the owner are the same person, but it is not required. The owner is the purchaser of the annuity, pays the premiums and has the right to surrender the annuity. The owner is also responsible for any taxes due upon surrender or payout and is usually the person who names the beneficiary of the contract. The annuitant is the person whose age and life expectancy is going to be used to calculate the benefits of the annuity and who will receive the annuity payments. The beneficiary receives the death benefit upon death of the annuitant or the owner.

How Premiums are Paid

An annuity may be either a single premium or a multiple premium contract.

Single premium

Single premium contracts require you to fully fund the annuity contract in one single premium payment. You cannot add additional money to the account.

Multiple premium

Multiple premium contracts allow an annuity to be funded by means of premium payments over a period of time. There are two kinds of multiple premium contracts—flexible and scheduled. A flexible premium contract lets you pay as much as you want, whenever you want, within set limits. A scheduled premium contract spells out the amount and frequency of your premium payments.

When Benefits are Paid

Immediate or Deferred

An annuity may be either immediate or deferred. If you want to begin receiving income immediately, consider an immediate annuity. Immediate annuities, usually purchased with a single premium, provide income payments that start no later than one year after you pay the premium. The reason for buying an immediate annuity is to obtain immediate income for the purpose of retirement.

If you are years away from retirement, consider a deferred annuity. Deferred annuities provide income payments that often start many years later. Deferred annuities have an accumulation period, which is the time between when you start paying premiums and when income payments start. The main reason for buying a deferred annuity is to accumulate money on a tax-deferred basis, which can then provide an income at a later date.

How the Money is Invested

Fixed or Variable

There are two basic types of annuity contracts—fixed and variable. At the time you buy an annuity contract you will select between a fixed or variable. This determines how earnings are credited in your contract.

A **fixed annuity** provides fixed-dollar income payments backed by the guarantees in the contract. During the accumulation period of a fixed deferred annuity, your money (less any applicable charges) earns interest rates set by the insurance company spelled out in the annuity contract. Every fixed annuity has a current interest rate and a minimum guaranteed interest rate. The company guarantees that it will pay no less than a minimum rate of interest. During the payout period, the amount of each income payment to you is generally set when the payments start and will not change.

An **indexed annuity** is a type of fixed annuity, but its returns are based upon the performance of a market index, such as the Standard & Poor’s 500 Composite Stock Price Index (the S&P 500), the Dow Jones Industrial Average (DJIA), or the National Association of Securities Dealers Automated Quotations (NASDAQ).

The annuity's principal investment is protected from losses in the market, while gains add to the annuity's returns. These types of annuity contracts are complex and the amount of interest that is credited and when it gets credited to your annuity will vary depending on the particular contract.

Read your annuity contract carefully when you receive it. Ask your insurance agent or insurance company to explain anything you do not understand. If you cannot get answers to your questions, call the Office of the Commissioner of Insurance (OCI) at 266-0103 (in Madison) or toll-free 1-800-236-8517 (statewide).

A **variable annuity** offers a range of investment or funding options. During the accumulation period of a variable annuity, the insurance company puts your premiums, less any applicable charges, into a separate account. You decide how the company will invest those premiums, depending on how much risk you want to take. You may put your premium into a stock, bond, or other account, with no guarantees, or into a fixed account, with a minimum guaranteed interest rate. During the payout period of a variable annuity, the amount of each income payment to you may be fixed (set at the beginning) or variable (changing with the value of the investments in the separate account).

Remember that you, the owner, or annuitant, bear the investment risk as the value of the variable annuity increases or decreases based upon investment performance of the security. For this reason you should be certain that the annuity purchased is suitable for your needs and investment tolerance.

Annuity Contract Features

The value of your annuity consists of the premiums you have paid, less charges, plus interest credited. This value is used to calculate the amount of benefits that you will receive. Charges, interest, surrender rights, and benefits are explained below.

Typical charges

There are many types and amounts of charges. Companies may refer to these charges by different names. Some annuities are “front loaded,” which means that most of the costs to the company are charged to you in the beginning. Some are “back loaded,” which means that most of these costs are charged to you later on. Others spread their charges evenly throughout the life of the annuity. Some charges will be fixed by the contract while some may be changed by the company from time to time.

Front loaded vs. Back loaded

Before buying an annuity you should know all of the charges that you will pay and when you will pay them. Also, you should understand how these charges might affect the actual amount of money that will accumulate from your premium payments. A typical contract might contain one or more of the following types of charges:

Percentage of Premium Charge
This charge, often called a “load,” is deducted from each premium before any interest is added. The percentage may reduce after the contract has been in force for a certain number of years or after the total premiums paid have reached a certain level.

Contract Fee
This is a flat dollar amount charged either once at the time of issue or charged once each year.

Transaction Fee
This is a fixed charge per premium payment or other transaction.

Surrender Charge

This charge is usually a percentage of the value of the contract or of premiums paid. The percentage may be reduced or eliminated after the contract has been in force for a certain number of years. Sometimes the charge is a reduction in the interest rate credited. Sometimes the charge is eliminated if the interest rate declared by the company falls below a certain level.

Interest rates

During the accumulation period, your money, less any applicable charges, earns interest at rates that change from time to time. Usually, what these rates will be is entirely up to the insurance company.

Current interest rate

The current rate is the rate the company decides to credit to your contract at a particular time. The company will guarantee it will not change for some time period.

The initial rate is an interest rate the insurance company may credit for a set period of time after you first buy your annuity. The initial rate in some contracts may be higher than it will be later. This is often called a bonus rate.

The renewal rate is the rate credited by the company after the end of the set time period. The contract tells how the company will set the renewal rate, which may be tied to an external reference or index.

Minimum guaranteed rate

The minimum guaranteed interest rate is the lowest rate your annuity will earn. This rate is stated in the contract.

Multiple interest rates

Some annuity contracts apply different interest rates to each premium you pay or to premiums you pay during different time periods.

Other annuity contracts may have two or more accumulated values that fund different benefit options. These accumulated values may use different interest rates. You get only one of the accumulated values depending on which benefit you choose.

Surrender rights

Most annuities allow you to surrender your annuity for its total accumulation value or withdraw a portion of the value if income payments have not yet started. However, a surrender charge may be deducted from the amount surrendered or withdrawn. This charge is usually a percentage of the accumulated value of the contract, the premiums paid, or the portion withdrawn.

Usually apply to surrenders or withdrawals

Surrender charges usually apply to surrenders or withdrawals you take during a certain number of years after you purchase your annuity. Surrender charges may gradually decrease each year the contract remains in force. Your annuity may also have a limited, free withdrawal feature that lets you withdraw, for example, 10% of your contract value annually without a surrender charge. Sometimes annuities waive withdrawal charges in certain situations, such as death, confinement in a nursing home, or terminal illness.

There may be certain tax penalties for early surrenders. Be sure you understand any tax implications before surrendering an annuity contract.

Benefits

Annuity contracts provide a number of benefits. While the annuity income benefit is the primary one, other benefits are also important. Some of the more important ones are described below.

Annuity income benefit

Companies may offer various income payment options. You (the owner) or another person that you name may choose the option. Make sure your agent goes over each option with you thoroughly so that you choose an option that is most appropriate for your needs. It is very important to understand that once a payout option is chosen and you start receiving payments that option cannot be changed. The most commonly available annuity income options are:

Common income options

Straight Life
The annuity income benefit is paid as long as you are alive. There are no further payments to anyone after your death.

Life With Period Certain
The annuity income benefit is paid for as long as you are alive. The company guarantees to make payments for a set number of years even if you die. If you die before the end of the period referred to as the "period certain," the annuity will be paid to your beneficiary for the rest of that period. A typical period certain is usually 10 or 20 years. If you live longer than the period certain, you will continue to receive payments until you die.

Joint and Survivor
The annuity income benefit is paid as long as either you or your beneficiary is still alive. You may choose to decrease the amount of the payments after the first death. Because the survivor feature is an added benefit, each income payment is smaller than in a life-only option.

Death benefit

Most contracts provide that, if you die before the annuity payments start, the contract value will be paid to your beneficiary. Some contracts provide that the death benefit will be the total premiums paid if that amount is greater than the value of the contract at death.

Waiver of premium

Some companies offer a benefit which will pay premiums for you if you become disabled. A charge is made for this benefit.

Replacing your Annuity

Replacement occurs when a person purchases new life insurance or an annuity and the person's existing life insurance or an annuity has been, may possibly be, or will be lapsed, surrendered, or all or a portion of the existing policy's cash or loan value is used in connection with the purchase of new life insurance or an annuity. If replacement is involved, Wisconsin law requires you to be given and sign an Important Notice form that provides important information concerning replacement transactions. If the new contract is with a different insurance company, the new company must notify the existing insurance company of the possible replacement. The existing company or its agent may contact you to try and persuade you not to replace your existing policy.

Remember, if you replace an existing annuity, you may lose a portion of the annuity's value as a result of surrender charges or penalties. It is likely you will also be subject to a new surrender period before you can withdraw money from the new contract without a penalty. Unless you plan to hold the annuity for a significant amount of time, you may be better off keeping the annuity you already have.

Replacement may or may not be in your best interest. You should make a careful comparison of the costs and benefits of your existing policy and the new policy. Ask the company or agent that sold you your existing policy to provide you with information concerning your existing policy.

Once you have received the new contract, you have 20 days to decide if you want to keep it. During this "free-look" period, you can return the policy to the agent or company for a full refund of your initial premium. Read your annuity contract carefully when you receive it. Ask your insurance agent or insurance company to explain anything you do not understand. If you cannot get answers to your questions, call OCI at 266-0103 (in Madison) or toll-free 1-800-236-8517 (statewide).

Retirees and Annuities

One of the reasons for buying an annuity is to increase financial security in retirement. An annuity may not be the best choice for people who are close to retirement or who have already retired.

The tax consequences and long holding periods necessary to make a deferred or variable annuity attractive are investment options that probably do not make sense for retirees.

You should exercise caution if you are older or retired. Senior consumers are frequent victims of financial abuse. Choose a qualified financial advisor or an insurance agent you trust to help you decide if an annuity is the right choice for you.

Wisconsin's Suitability Law

In November 2004, Wisconsin enacted a new law regarding the suitability of annuity sales and recommendations to senior consumers age 65 or older. In April 2008 Wisconsin amended its suitability law to apply to all consumers regardless of age. This change first applies to annuity contracts issued on or after October 1, 2008.

Under Wisconsin's suitability law, insurance companies and agents offering annuity products to consumers are required to make reasonable efforts to obtain information from a consumer about his or her financial status, tax status, investment objectives, and any other information that is reasonably appropriate for determining suitability before making a recommendation involving an annuity to a consumer. An insurance company or agent may not make a recommendation that results in the purchase or exchange of an annuity unless there are reasonable grounds to believe that the recommendation is suitable for the consumer based on the information disclosed by the consumer.

Taxes

Tax-deferred is not the same as tax-free

Under current federal law, annuities receive special tax treatment. Income or tax on annuities is deferred, which means you are not taxed on the interest your money earns while it stays in the annuity. Tax-deferred accumulation is not the same as tax-free accumulation. An advantage of tax deferral is that the tax bracket you are in when you receive annuity income payments may be lower than the one you are in during the accumulation period. You will also be earning interest on the amount you would have paid in taxes during the accumulation period. Most states' tax laws on annuities follow the federal law.

Penalties for early withdrawal

Part of the payments you receive from the annuity will be considered as a return of the premiums you have paid. You will not have to pay taxes on that part. Another part of the payments is considered interest you have earned. You must pay taxes on the part that is considered interest when you withdraw the money. You may also have to pay a 10% tax penalty if you withdraw the accumulation before age 59 ½. The Internal Revenue Code also has rules about distributions after the death of a contract holder.

Annuities are a way to accumulate money to be used at some future date to enhance income. But you must remember that when you begin to withdraw money from the annuity, you must then pay taxes on your gain.

Another point to remember is that at the time of total withdrawal of funds, which most often occurs upon the death of annuitant/owner that the entire gain in the annuity is subject to income taxes when received by the beneficiary.

For example, you own a deferred annuity into which you originally deposited $50,000 and now it is worth $70,000. When your beneficiary receives the annuity, income taxes will be due on the $20,000.

Annuities used to fund certain employee pension benefit plans (those under Internal Revenue Code Sections 401 (a), 401 (k), 403 (b), 457, or 414) defer taxes on plan contributions as well as on interest or investment income. Within the limits set by the law, you can use pretax dollars to make payments to the annuity. When you take money out, it will be taxed.

You can also use annuities to fund traditional and Roth Individual Retirement Accounts (IRAs) under Internal Revenue Code Section 408. If you buy an annuity to fund an IRA, you will receive a disclosure statement describing the tax treatment.

How Much Should I Buy?

Before you decide to buy an annuity, ask yourself these questions:

- Depending on my needs or age, is this annuity right for me? Taking money out of an annuity may mean you pay taxes. Also, while it is sometimes possible to transfer the value of an older annuity into a new annuity, the new annuity may have a new schedule for charges that could mean new expenses you must pay directly or indirectly.

- How much annuity income will I need in addition to my social security, pension, savings, and any other income or investment sources?

- Will I need an income only for myself or also for someone else?

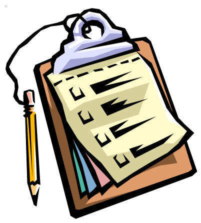
- How much can I afford to pay in premiums?

- How will the annuity contract fit in with my total financial planning?

- How long can I leave money in the annuity?

- When will I need income payments?

Things to Consider Before You Buy



√ Do not buy the first contract you are offered. Take your time. Shop around.

√ Compare contract summaries and policy benefits for similar contracts from several companies. Choose the one that best fits your needs at the most favorable premium rate.

√ Ask questions. Your annuity contract may represent a considerable investment and may significantly impact your family's future.

√ Be certain that you understand the effect of all charges and penalties that you may incur under the contract.

√ If you are buying an annuity for an IRA or another tax deferred retirement program, make sure that you are eligible. Also make sure that you understand any restrictions connected with the program. Ask your accountant about any potential tax consequences.

Selecting an Agent or Insurance Company

For the most part, insurance is sold directly through an insurance company or through an agent or broker. An independent agent may represent more than one and sometimes several insurance companies. An exclusive or captive agent sells solely for one insurance company or group of related insurance companies.

Verify that the agent and company you choose to do business with are both licensed in Wisconsin. All companies and agents doing business in Wisconsin are required to be licensed by OCI. To find out if a company or agent is licensed in Wisconsin, call 266-0103 (in Madison) or toll-free 1-800-236-8517 (statewide) or visit OCI's Web site at oci.wi.gov.

Do Not Pay Cash. When you purchase an annuity, make your check or money order payable to the insurance company, **not the agent**. Be sure to get a receipt.

Financial Strength of Company

An annuity is not "risk free" or guaranteed safe."

You should consider checking with at least two ratings organizations to evaluate a company's strength.

An annuity is only as sound as the insurance company that issues it. Financial strength and being able to meet financial obligations to policyholders is very important.

Independent organizations such as A. M. Best, Standard & Poor's, Moody's, Fitch Ratings and others publish financial ratings. The ratings used by these agencies represent the organization's opinions of the insurance company's financial condition and their ability to meet their obligations to policyholders. These rating organizations do not rate the quality of the company's policies, practices, agents, or service. You should consider checking with at least two organizations to evaluate a company's strength. If you want to check on an insurance company's financial stability, you can check the reference section of your public library for published ratings, call OCI at 266-0103 (in Madison) or toll-free 1-800-236-8517 (statewide), or check with your insurance agent.

Wisconsin Insurance Security Fund

Every state has a safety net to protect insurance consumers from financial loss in the rare instance that a company becomes insolvent. This safety net is called a "guaranty fund." The guaranty funds are established by state law and are composed of licensed companies in the state. They pay the claims of policyholders and other claimants of an insolvent insurance company. The money to pay the claims against the insurance company comes from assessments made against all of the companies that are members of the guaranty fund.

In Wisconsin, the fund is called the Insurance Security Fund (Fund). The Fund is created by state law and is funded by assessments of insurance companies licensed to do business in Wisconsin. In general, the Fund protects residents for most claims of licensed companies in liquidation. The Fund should not be relied upon to eliminate all risks of loss to companies due to insurance company insolvency. Some types of policies may not be fully covered and significant delays could occur in settling obligations in cases of liquidation.

Questions about the coverage and limitations of the Fund can be addressed to:

Wisconsin Insurance Security Fund
2820 Walton Commons West, Suite 135
Madison, WI 53718-6797
(608) 242-9473
www.wilifega.org
(Updated December 2008)

Problems with Insurance?

If you are having a problem with your insurance, you should first check with your agent or with the company that sold you the policy. If you do not get satisfactory answers from the agent or company, contact OCI. A complaint form is included in the back of this booklet. Make sure you have included detailed information about your insurance problem. Be sure that you have included the correct name of the insurance company from which you bought the policy. Many companies have very similar names. Listing the wrong name may delay the investigation of your complaint.

OCI investigates complaints to determine if any insurance laws have been violated. If so, the office may take action against the agent or company involved. These actions include imposing fines or suspending or revoking licenses. OCI publishes complaint summaries each year listing those companies that have received the most complaints. This is one way consumers have of judging the service given by insurance companies. For more information, call OCI at 266-0103 (in Madison) or toll-free 1-800-236-8517 and request a copy of *Insurance Complaints and Administrative Actions* or you can review the publication on OCI's Web site at oci.wi.gov/pub_list/pi-030.htm.

Glossary of Terms

Accumulation phase: The period of time where all the premiums are paid into the annuity and the money grows tax-deferred.

Agent: A person licensed by a state insurance department who solicits, negotiates, or effects insurance contracts on behalf of one or more insurance companies.

Annuitant: A person who receives benefit payments from an annuity.

Annuitize: A method of receiving annuity benefits through a series of income payments for life or some other defined period of time.

Annuity: A written contract with a life insurance company which guarantees an income for life or some other defined period in exchange for premiums you pay.

Application: A statement of information made by a person applying for life insurance. The information gathered helps the insurance company assess whether the risk presented by the applicant is acceptable.

Back loaded: Company expenses that are charged at the time benefits begin.

Beneficiary: The person named in the annuity contract as the person who receives benefit payments if the annuitant dies.

Current interest rate: The interest rate an insurance company promises to pay for a specified time period. It is based on the prevailing interest rates in the economy.

Death benefit: The annuity benefits that are paid to the beneficiary upon the death of the contract owner or annuitant.

Fixed annuity: An annuity contract that guarantees a minimum rate of interest, as well as a higher current rate of interest for shorter periods, during the accumulation phase of a deferred annuity.

Free look period: A period specified in the contract during which you can decide whether to keep an annuity or return it for a full refund of your premium. In Wisconsin your free look period is 20 days when you buy an annuity contract to replace one you already had.

Front load: Company expenses that are charged at the beginning of a premium payment period.

Guaranteed interest rate: A minimum interest rate specified in a fixed annuity. The actual rate the insurance company credits your contract at any given time may be higher but can never be lower.

Immediate annuity: An annuity contract in which annuity payouts begin immediately or within one year.

Indexed annuity: A contract that combines a guaranteed minimum interest rate with earnings linked to the performance of an external stock or bond index.

Initial interest rate: The interest rate the insurance company may credit for a set period of time after you first buy your annuity. The annuity contract will specify how long the initial interest rate is guaranteed.

Interest: The fees that bond issuers, banks, and other financial institutions pay for the use of borrowed money.

Joint and survivor annuity: An annuity that continues income payments as long as one annuitant remains alive; the payment amount may be reduced after one annuitant dies.

Period certain: An income option offered by an immediate annuity where the contract owner can select to receive periodic payments for a specified period of time. The payout amount is determined by the contract value and the length of the period selected.

Premium: The money you pay to the insurance company to fund an annuity contract.

Surrender charge: A fee the insurance company will charge you if you cash in (surrender) an annuity before the payout phase begins, or if you make a withdrawal larger than specified in the contract.

Tax-deferral: Taxes on earnings are postponed until any earnings are withdrawn from the annuity.

Variable annuity: An annuity contract that allows you to allocate premium among a number of investment portfolios (sub-accounts). The policy's contract value can fluctuate in accordance with the performance of the underlying investments.

Withdrawal privilege: A provision in many annuity contracts that allows you to withdraw an amount less than the surrender value, without paying a surrender charge. Any withdrawal may be subject to taxes and penalties.