California Insurance Agents’
8-Hour Annuity Training Course

Sandi Kruise Insurance Training
Quality Education for Insurance Professionals

www.kruise.com
1-800-517-7500
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I. HISTORICAL DEVELOPMENT OF ANNUITY CONTRACTS

The Purpose 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 to continue throughout a specified period of time or for the duration of a designated life or lives.

According to the dictionary, the meaning of the word annuity is “annual payments.” When an annuity is purchased, the insurance company agrees to systematically distribute the annuity’s value as income over a specified period of time or for the duration of a designated life or lives.

A. How they have evolved to the products and practices we see today as they relate to consumers

PRODUCT HISTORY

The first modern annuity was sold in 1973. Annuity products have experienced incredible growth over the past two decades. This growth came initially from the fixed annuity business; however, in the mid 1990s, the variable annuity business really took off. According to the American Council of Life Insurance, total annuity sales were $6.3 billion in 1980, $58.5 billion in 1991, $100 billion in 1995 and more than $125 billion in 1999 and $168 billion in 2002. Today, annuity premiums account for roughly one-third of total income insurance companies receive. LIMRA, an independent service that tracks the insurance industry, reported that fixed and variable annuity sales amounted to $98.5 billion in 1995. By 1999 that figure had ballooned to $155 billion.

The significant growth in annuities during the mid- to late 1980s was, in part, an outcome of improved product design, but primarily from expanded distribution. In addition to stockbrokers and insurance agents, two new distribution systems emerged: NASD broker-dealers and banks. This helped pave the way for a wider consumer awareness and acceptance of the annuity product. Annuities are extraordinarily popular in modern times, but they’re not new. In fact, annuities can actually trace their origins back to Roman times. Contracts were known as annua, or “annual stipends” in Latin. Back then, Roman citizens would make a one-time payment to the annua, in exchange for lifetime payments made once a year. During the 17th century, annuities were used as fundraising vehicles. In Europe, governments would then create a tontine, promising to pay for an extended period of time if citizens would purchase shares today. Annuities made their first mark in America during the 18th century. In 1759, a company in Pennsylvania was formed to benefit Presbyterian ministers and their families. It wasn't until 1912 that Americans could buy annuities outside of a group.

Annuity growth from that point on was steady, but annuities really started to catch on in the late 1930s. In the midst of the Great Depression, insurance companies were seen as stable financial institutions.

In 1952, the first variable annuity was created. Variable annuities credit interest based on the performance of separate accounts inside the annuity. Variable annuity owners could choose what type of accounts they wanted to use, and often received faster growth in exchange for greater risks they assumed.

The Annuity Yesterday and Today

Over the past 25-30 years, the annuity has changed dramatically. Investment philosophies, distribution, marketing and product design all have grown with the expansion of the market. The annuity remains one of the only tax-deferred methods of accumulating long-term retirement assets. The historical definition of the annuity was to provide an income stream guaranteed for life. It is used today in a wide variety of financial planning applications to both accumulate and distribute assets earmarked for the long term.
Deferred annuities, with emphasis on tax deferral and asset growth, shifted the use from an income vehicle to an accumulation vehicle. Most of the innovative product designs that emerged in the 1980’s and 90’s applied to deferred annuities. Many deferred annuities were designed on the assumption that buyers would surrender or exchange the products for their accumulated value instead of annuitizing. Since their beginning, the design of annuity products has continued to evolve. Agents and consumers have a great amount of choice when it comes to selecting an annuity. The market has evolved into these three primary categories:

**Fixed Annuities**
- Earnings come from Insurers investments which are very conservative but low-yield
- Guarantees minimum interest rates for the policy duration
- High level of safety but may not keep up with inflation
- Principal is not subject to loss

**Equity Indexed Annuities**
- Earnings are based on changes in a major market index (i.e. S&P 500®)
- Guarantees minimum interest rates for the policy duration
- Principal is not subject to loss

**Variable Annuities**
- Earnings are based on performance of investment subaccounts
- Designed to cope with inflation
- Principal is subject to loss

Each of these will be described in greater detail later in the course.

**B. Market overview**

MARKET OVERVIEW

Over the last decade and a half, a number of research studies have been undertaken to better understand the dynamics of the annuity market.

![Annual Sales - Individual Annuities](image)

**Source:** American Council Of Life Insurers, 2004
When annuities first became popular in the late 1970s, fixed deferred annuities were marketed to older individuals who previously kept their money in 5¼ or 5½ percent savings accounts at their bank or savings and loan, the earnings on which were subject to income tax. Annuities offered a safe, tax-deferred alternative for their savings.

The most recent surge in the annuity market came in the mid-to-late 1990s with the growth of variable annuities in response to the unprecedented growth of the stock market. Variable annuities tend to be popular with both younger and older purchasers, capturing assets that would otherwise be invested in mutual funds.

In the mid-1990s equity indexed annuities were introduced with interest crediting linked to a stock index, such as the S&P 500 or the Dow-Jones Industrial Average. A type of fixed annuity with guaranteed principal, EIAs also offer the potential for higher rates of return tied to the stock market. Because most annuities guarantee the return of the premiums paid into the contracts regardless of penalties, annuities also are marketed as alternatives to corporate and municipal bonds, whose values fluctuate with changing interest rates. When interest rates escalate in the open market, the value of any given bond fluctuates inversely. The higher the current interest rate, the less the old bond is worth. In contrast, a fixed annuity typically guarantees, at a minimum, to return the full premium or premiums deposited, and it protects its owner against loss of principal and market risk.

When annuities were first introduced, their underlying investment portfolio consisted of high-grade corporate bonds. Today’s portfolios are much more diversified including various types of mortgages and asset-backed securities, as well as the traditional corporate bonds which still make-up most of the investment portfolio. Currently the annuity market has more than $1 trillion in assets under management. According to VARDIS, in 2000 Annuities were sold by the following:

- Career Life Agents 31%
- Stockbrokers 27%
- Independent Planners 24%
- Banks 15%
- Direct Response 3%

Along with the innovation of new designs for fixed, equity-indexed and variable annuities, carriers have also added features that can benefit policyholders and their families. Each of these features will be discussed in this course.
II. THE PRIMARY USES OF ANNUITIES

A. Annuities defined

1. 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.

An annuity is a contract between an individual and an insurance company. The annuitant agrees to pay the insurance company a single payment or a series of payments, and the insurance company agrees to pay the annuitant an income, starting immediately or at a later date, for a specified time period. Under current tax law, money put into an annuity grows on a tax-deferred basis until the annuitant begins receiving his accumulated fund as an income. That means that one hundred percent of earnings are reinvested in an annuity and allowed to compound without having to pay taxes on earnings. Once there was only one type of annuity. The sole function of an annuity was to convert a lump sum of money into a stream of income that was guaranteed to last for life. Today there are many types of annuities. Each type of annuity is designed to meet a particular financial concern, situation or need. Under an annuity contract, an insurance company converts a given sum of money into a series of periodic income payments that are calculated actuarially and guaranteed to extend for a certain number of years or for the duration of an individual's life. This is the foundation upon which all annuity products exist.

Like life insurance, annuities rely on the law of large numbers as well as mortality and investment experience. Like life insurance, annuities protect against the loss of income. However, unlike life insurance, an annuity focuses not on how soon a person will die but on how long that person will live. Annuity payments protect against the risk that a person will live too long and outlast his or her income. To properly evaluate annuities and make appropriate product recommendations, the agent must understand that all annuities are long-term planning products suitable only for clients with long-term investment horizons, such as retirement. With few if any exceptions, they are not appropriate for short-term needs or objectives. Annuities are the only investment vehicles that can guarantee investors that they will not outlive their income, and they do this in a tax-favored manner. In addition, annuities are available with a host of differing features to meet a wide variety of investor needs.

B. How does the utilization of annuities help fulfill consumer's retirement goals as compared to other financial planning vehicles? (e.g. certificates of deposit, mutual funds, bonds, savings accounts, etc)?

How the Annuity Helps Fulfill Consumer's Retirement Objectives

Annuities have become a popular choice among agents and consumers alike. The IRS gives annuities preferred tax treatment. Through a variety of designs - fixed, equity-indexed and variable - annuities can accommodate many long-term objectives including the ability to create a reliable and systematic income stream for the owner. The two primary tax advantages of annuities are: that earnings grow on a tax-deferred basis and payouts receive favorable income tax treatment.

To see how powerful these benefits are in comparison with other income alternatives, here is an example:

Mary is 60 years old. Her income puts her in the 27% tax bracket, She plans to retire in five years. The $100,000 she has saved towards her retirement is currently invested in a CD earning 8%. A fixed annuity is also paying 8%. In her 27% tax bracket, the after-tax rate of return on a CD paying 8% is 5.84%. In five years, Mary $100,000 CD will be worth $132,815 on an after-tax basis. But if she bought a $104,000 single premium deferred annuity paying 8%, the annuity would be worth $146,933 in five years. Even if she surrendered her annuity at that point and paid tax at a rate of 31% on her gain, she would have $132,384. However, she wouldn't have to surrender her annuity at that point. She could convert the entire $146,933 into a single life annuity that would guarantee her an income, according to the insurer's annuity tables, of $938 for life. Because of the exclusion ratio, she would pay tax on only $522 of that amount. At a tax rate of 15%, her annuity income would be reduced by only $78 per payment, leaving her spendable...
income of $860. The interest on her 8% CD would provide her with only $882 of income per month, and she would pay tax on that entire amount. At a tax rate of 15%, her income from a CD would be reduced by $132 per month, leaving her with only $750 of spendable income per month. An annuity would provide her with $110 more per month in spendable, after-tax income. If Mary kept her CD, she might be forced to begin spending her principal to make ends meet, but then she would see her interest earnings fall increasingly each year. If Mary didn't want to convert her annuity fund to a single life annuity, she could still avoid having to pay tax on her entire gain by initiating a systematic withdrawal plan.

The following table shows the average rates of return on several investments over a five-year period along with the range of renewal rates paid on flexible premium deferred annuities and single premium deferred annuities included in a survey covering the same period. The figures in the table show that fixed annuities can provide an accumulation rate that compares favorably with the returns available on other interest-bearing financial investments.

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<td>3.65-8.75</td>
<td>3.00-8.60</td>
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**HOW ANNUITIES COMPARE TO OTHER INVESTMENTS**

**Certificate of Deposit**

Like annuities, CDs are not tax free; the principal is protected and free of market risk; a charge applies to early withdrawals; and there is limited liquidity. Unlike annuities, CDs are not tax deferred; there is no 10% tax penalty for pre 59½ distributions, there is no provision for tax-advantaged lifetime income; the CD does not avoid probate and it cannot help reduce the taxation of social security.

**Money Markets**

Like annuities, money market accounts are free from market risk and principal risk and neither investment is tax free. Unlike annuities, however, there is no tax penalty for early distribution nor is there a fee; money market accounts have more liquidity than annuities but do not offer any provision for tax-advantaged lifetime income or avoid probate or help reduce tax on social security benefits.
**Mutual Funds**

Neither annuities or mutual funds are tax-free investments. Unlike annuities, mutual funds are not tax deferred, they do not provide protection from either market or principal risk; there is no fee for early withdrawal nor is there a tax penalty for pre 59½ distributions; mutual funds do provide more liquidity but they do not provide tax-advantaged lifetime income, avoid probate, or help to reduce taxation of social security benefits.

**Stocks**

Neither stocks nor annuities are tax-free. Unlike annuities, stocks are not tax deferred; stocks are subject to both market risk and principal risk; stocks allow more liquidity than annuities; there is no fee for early withdrawals nor is there any tax penalty; stocks do not avoid probate nor do they help reduce tax on social security benefits.

**Bonds**

Bonds have about the same amount of liquidity as annuities. Unlike annuities, bonds are not free from market risk and, with the exception of government bonds, they are also subject to principal risk. Most bonds do not contain a charge for early withdrawal and are not subject to the 10% tax penalty for pre age 59½ withdrawal either. Bonds do not provide a tax-advantaged lifetime income nor do they avoid probate or help reduce taxation on social security benefits.

**Commodities**

Neither annuities or commodities are tax-free investments. Both allow access to investments, however the commodities do not charge a fee for access nor a tax penalty for early withdrawal. Unlike annuities, commodities do not provide a tax-advantaged lifetime income nor do they avoid probate or help reduce taxation of social security benefits.

**Options**

Both options and annuities allow access to funds and neither is a tax free investment. Unlike annuities, options are not tax-deferred; they are subject to both market risk and principal risk; options may charge a fee for early withdrawals but are not subject to the 10% tax penalty for pre age 59½ withdrawals. Options don’t provide a tax advantaged lifetime income nor do they avoid probate or help to reduce tax on social security benefits.

**Limited Partnerships**

Neither limited partnerships nor annuities are tax-free investments. Unlike annuities, limited partnerships are not tax deferred. Principal is free from market risk however they don’t provide safety of principal. There is no access to the account value therefore there is no penalty tax on pre 59% withdrawals. There is no provision for tax-advantaged, lifetime income, they don’t avoid probate nor do they reduce taxation of social security benefits.

**Promissory Notes**

Like annuities, promissory notes provide safety of principal. Neither promissory notes nor annuities are tax-free investments. Unlike annuities, promissory notes are not tax deferred. Principal is not free from market risk. No access to the account value therefore there is no penalty tax on pre age 59½ distributions. Promissory Notes do not provide tax-advantaged lifetime income; do not avoid probate and do not reduce taxation of social security benefits.
Real Estate Investment Trusts (REIT)

Like annuities, there is access to the account value. Neither Real Estate Investment Trusts nor annuities are tax free. Unlike annuities, Real Estate Investment trusts are not tax deferred; principal is not free from market risk. REITs do not provide safety of principal nor do they charge for early withdrawal. There is no 10% penalty for pre age 59½ distributions. REITs do not provide tax-advantaged lifetime income; do not avoid probate nor do they reduce taxation of social security benefits.

Viatical Settlements

Like annuities, viatical settlements are free from market risk. Neither viatical settlements nor annuities are tax free. Unlike annuities, viatical settlements are not tax deferred; do not provide safety of principal; do not allow access to the account value nor do they apply a penalty for pre age 59½ distributions, there is no tax-advantaged lifetime income. Viatical Settlements don’t avoid probate nor do they reduce taxation of social security benefits.

Savings

Like annuities, savings are free from market risk and principal risk and neither investment is tax free. Unlike annuities, however, there is no tax penalty for early distribution nor is there a fee; savings accounts have more liquidity than annuities but do not offer any provision for tax-advantaged lifetime income or avoid probate or help reduce tax on social security benefits.
III. INTRODUCE THE TYPES OF ANNUITIES RECOGNIZING THE VARIOUS CLASSIFICATIONS OF ANNUITIES. 5%

TYPES OF ANNUITIES

Many types of annuities and numerous variations and options are available to consumers. The primary types of annuities can be classified as follows:

- How the annuity funds are invested (fixed or variable)
- When the annuity payments begin (immediate or deferred)
- The method of premium payment (single or periodic)

A. Annuity type according to when benefits are paid out

IMMEDIATE VS. DEFERRED ANNUITIES

Here the focus is on when payouts begin. With an immediate annuity, the insurer agrees to start making payments soon after the contract is signed. Immediate annuities are commonly used to convert a large amount, such as a lump-sum distribution from a qualified pension or profit-sharing plan, into an income stream. Payments from deferred annuities are delayed or deferred for a period of time after the premiums or contributions have been completed. Deferred annuities are frequently used when a person has cash to invest before retirement and wishes to postpone annuity payments until retirement or later.

1. Define immediate annuity

IMMEDIATE ANNUITIES

An immediate annuity is designed to generate income payments almost immediately after it is purchased. Immediate annuity contracts can only be purchased with a single premium. Then, within a very short time, the contract "annuitizes" and begins to generate payments on a regular, structured basis. Each annuitized payment consists partly of principal and partly of interest earnings. Most annuity payments are made monthly; however, many insurers allow the annuitant to elect a quarterly, a semiannual or an annual payment schedule.

How long an immediate annuity generates an income flow and the amount of each payment depends on a number of factors, such as the total amount of the annuity fund and the distribution or settlement option the contract owner selects. Payments can be made for a specified period of time, such as 5, 10 or 20 years (a term certain option); for the duration of the annuitant's life (a life-income option); or for the duration of two lives (a joint and survivor option). Other payout options combine a term certain option with a life income option. Given a specified amount of annuity funds, the longer the period of income payments and the more guarantees the payout option provides, the smaller the amount of each payment. The income flow from immediate annuities can be either fixed or variable.

Under a fixed immediate annuity, the annuitant is guaranteed an income flow without risk that market fluctuations will affect the income amount; the insurance company absorbs the market risk associated with the investment of the annuity funds.

A variable immediate annuity transfers the investment risk to the annuitant. This means that once an income stream is created, the payments can increase or decrease based on the performance of the underlying investments.

Immediate annuities solve the problem created by the uncertainty of whether a given sum of money will be sufficient to support someone for the remainder of his or her life.
For example, a man, who is age 60, in good health, and recently retired has a lump sum of $100,000, but no other sources of income. He wants to enjoy the best lifestyle possible during his retirement. The problem is how long will the money have to last?

According to the 1980 Commissioners Standard Ordinary Mortality Table, the average life expectancy for a man age 60 is 17.5 years. He could plan his expenditures so that his money runs out when he turns age 77½. But 17.5 years is just an average—what if he lives past that age? There's also the possibility that he will die sooner than the average, in which case his money will not have been used to its fullest advantage during his retirement. If he spends too much now, sometime in the future he may find he has to reduce his spending on food or other necessities to make up for it. An immediate annuity solves the problem by guaranteeing an income for life. According to one insurance company he can purchase a monthly income of $601 for life with his $100,000. Now he has a definite figure to budget with and can spend the money without having to worry about his financial future. He doesn't need to buy an immediate annuity to liquidate his funds. He could keep the $100,000 in his own interest-bearing account and withdraw $601 at the end of every month and his funds would run out at about age 77½. But if he were still alive at that point, he'd have no money left, whereas with the annuity, the insurance company would continue to pay him $601 a month no matter how long he lived. An individual cannot guarantee himself or herself a lifetime income except by purchasing an annuity. The guarantee of a lifetime income can only be accomplished through the pooling mechanism of insurance.

Immediate annuities provide many advantages to the buyer, such as:

- **Security** - the annuity provides stable lifetime income which can never be outlived or which may be guaranteed for a specified period;
- **Simplicity** - the annuitant does not have to manage his investments, watch markets, report interest or dividends;
- **Flexibility** - Payments can be received as frequently as needed to best meet the situation.
- **Stability** - Choosing a life option assures income that can't be outlived.
- **Choice** - Several different income payment options are available.
- **High Returns** - the interest rates used by insurance companies to calculate immediate annuity income are generally higher than CD or Treasury rates, and since part of the principal is returned with each payment, greater amounts are received than would be provided by interest alone;
- **Preferred Tax Treatment** - it lets them postpone paying taxes on some of the earnings accrued in a "tax-deferred" annuity when rolled into an immediate annuity (only the portion attributable to interest is taxable income, the bulk of the payments are nontaxable return of principal);

Since a Single Premium Immediate Annuity provides a guaranteed stream of payments to the annuity owner or annuitant, it is used in many instances where safety and timely income are the foremost concerns.

Here are some examples where an income stream makes sense:

- Retirement benefits from employment with lump sum
- Terminal funding needs
- Pension terminations with lump sums
- Structured settlements on personal injury, estate or divorce cases
- Professional sports contracts
- Loan guarantee transactions

Unlike deferred annuities, immediate annuities cannot be surrendered or returned. The purchaser has relinquished control of their lump sum to the insurance company in exchange for the income stream. The principal in an immediate annuity is not readily accessible. People who need more money than the income provided by the immediate annuity can minimize this drawback by keeping some of their retirement funds in a liquid account, such as a savings account or money market fund.

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2. Define deferred annuity

THE DEFERRED ANNUITY

With a deferred annuity, the contract specifies a future date that payments to the annuitant will begin. This date is referred to as the maturity date. The period before the maturity date on a deferred annuity is sometimes called the accumulation period. The period following the maturity date during which payments are made to the annuitant is known as the liquidation or distribution period. As with immediate annuities, the annuitant will receive payments according to the schedule in the contract.

A deferred annuity is characterized by two distinct periods: the accumulation period and the payout (or distribution) period. The accumulation period in a deferred annuity is the time during which funds, in the form of premium payments and interest earnings, are deposited into the contract and accumulate tax deferred. During the accumulation phase, the money grows tax-deferred until it is withdrawn. The power of compounded tax-deferral delivers an advantage in achieving long-term retirement and financial goals. By deferring tax, consumers earn interest on principal, earnings and the savings in taxes that would normally be paid on taxable investments. Suppose the client from our previous example decided to continue working until age 70. Since he has income from employment, he wants to delay the start of annuity payments for 10 years. He can pay his $100,000 as a premium on a deferred annuity designed to begin annuity payments at age 70. Meanwhile, the annuity funds will accumulate earnings that will add to the amount available for conversion into an income stream.

For example, if the annuity pays 8% interest during the deferral period, the fund will grow to $215,892 over 10 years. At that point, because of the increased amount of money available for conversion and because of the reduced life expectancy at this older age, he could receive a guaranteed lifetime income of $1,831 a month.

Fixed Deferred Annuities

Money invested earns a specified rate of return on a tax-deferred basis. The insurance company usually sets the rate of return every year with a guaranteed minimum rate of generally 3 percent. The actual rate often exceeds the guaranteed minimum. When individuals decide to start receiving income, the insurance company will then pay a fixed amount every month. The pay-out amount will depend on the rate of interest that the premiums have earned.

Variable Deferred Annuities

Premium payments are used by the insurance company to purchase stocks, bonds or other types of securities per the contract owner’s choice. Any increase in the value of the securities is tax-deferred. The amount of pay-out depends on how well the securities perform.

Payout Period

The deferred annuity enters the payout phase at some point in the future when the owner decides to withdraw the annuity using a systematic formula for disbursing the values, called annuitization. Most deferred annuities specify a maturity date – the point at which the contracts are scheduled to annuitize and begin generating monthly income payments. Annuitization options include:

- Life
- Term Certain
- Joint-Life
Instead of, or prior to, annuitization, the owner could distribute the value of the annuity in one of the following ways:

- Lump-sum distribution of the entire cash value
- Systematic withdrawals

**Advantages of Deferred Annuities**

There are a number of good reasons to consider a deferred annuity as part of a financial retirement plan:

- Income taxes on any earnings is postponed until the money is withdrawn, typically during retirement, when clients may be in a lower tax bracket.
- All earnings grow tax-deferred.
- Clients can put in as much money as they want.
- Unlike Individual Retirement Accounts (IRAs), there is no IRS restriction on the amount that can be contributed annually to deferred annuities with your after-tax money.
- Death benefits can be provided to heirs.
- If clients die prematurely, their annuity can offer a death benefit to beneficiaries without the costs and delays of probate.

3. **Distinguish between the characteristics of the two types**

**DIFFERENCES BETWEEN DEFERRED AND IMMEDIATE ANNUITIES**

**DEFERRED ANNUITIES**

- Includes both an accumulation and payout phase.
- Purchased to accumulate funds on a tax-deferred basis.
- Purchased with flexible premiums (allowing additional deposits) or with a single premium (one payment).
- Can be surrendered unless annuitization has already begun.

**IMMEDIATE ANNUITIES**

- Includes only a payout phase.
- Purchased to convert a lump sum to an income stream.
- Must be purchased with a single premium payment.
- Cannot be surrendered, except during the free-look period.

**B. Annuity type according to how and when premiums are paid**

**SINGLE VS. FLEXIBLE-PAYMENT ANNUITIES**

An annuity can be purchased in two ways:

- With one lump-sum payment (a **single-premium** annuity).
- With ongoing contributions (a **flexible-payment** annuity).
1. Define single premium annuities

**SINGLE-PREMIUM ANNUITIES**

A single-premium annuity is purchased with a single lump sum premium payable at the inception of the contract. Generally the contract owner is not allowed to make additional deposits into the contract. Most of the sales volume in the annuity business today, as in the past, has been single premium. All immediate annuities must be funded by a single-premium, although not all single premium annuities are immediate. The contract holder can deposit the money into the annuity in one lump sum and let it remain there collecting interest until some time in the future when they decide to begin receiving annuity payments.

Single premium annuities are ideal for people who have come into large cash sums. A single premium annuity will convert such amounts, for example, from an inheritance, from the sale of a business or a large piece of real estate, or from a qualified pension or profit-sharing plan lump-sum distribution, into a lifetime or certain fixed period stream of payments.

2. Define flexible premium annuities

**FLEXIBLE PREMIUM ANNUITIES**

Risk can sometimes be higher in flexible plans where mutual funds are chosen. More importantly, this risk is borne almost solely by the investor and not the insurance company. This **contrasts with many single premium plans**, focusing on fixed-rate products where the insurer bears all of the investment risk.

A flexible-premium annuity is one purchased with periodic premiums payable on a flexible schedule. All flexible premium annuities are deferred annuities. Flexible premium annuities are used widely to fund Individual Retirement Accounts (IRAs) and Tax-sheltered Annuities (TSAs). Many companies have set up preauthorized contributions to their flexible premium annuity products by systematically transferring periodic sums from contract owners’ checking or savings accounts into the annuities.

The duration of surrender charges tends to be somewhat longer and the charges somewhat higher. This is in part a result of additional administrative costs and the higher agent compensation typically found in flexible premium contracts. Flexible premium annuities require the insurer to handle smaller amounts of money more frequently, resulting in higher administrative costs as well as the additional cost of data processing support.

3. Distinguish between the characteristics of the two types

**SINGLE PREMIUM OR FLEXIBLE PREMIUM**

**Single Premium characteristics:**
- Purchased with one lump sum
- Can have immediate or deferral annuities
- Lower administrative costs

**Flexible Premium characteristics:**
- Purchased with many periodic payments
- Can only fund deferral annuities
- Higher administrative costs
- Longer surrender charges
C. Annuity type according to investment options offered

TYPES OF ANNUITIES ACCORDING TO INVESTMENT OPTIONS

There are three basic types of annuities:

- Fixed
- Variable
- Indexed

The difference is based on the underlying investments. **Fixed annuities** are invested primarily in bonds, bond funds or the insurer’s general account. **Variable annuities** are invested primarily in stocks, stock funds or stock index funds. **Equity indexed annuities** are fixed annuities tied to the rise or fall of an investment index.

**Fixed** annuity owners appreciate stability. Fixed annuities offer assurances that cannot be found anywhere else. **Variable** annuities allow clients to enjoy the upside of the market but subject them to investment loss as well. **Indexed** annuities minimize downside risk by guaranteeing that the annuity value will earn a minimum rate of interest and that they not decrease below the initial premium.

1. Define variable annuities

VARIABLE ANNUITIES

A variable annuity is a contract between the contract owner and an insurance company, under which the insurer agrees to make periodic payments to the annuitant, beginning either immediately or at some future date. They purchase a variable annuity contract by making either a single purchase payment or a series of purchase payments.

A variable annuity offers a range of investment options. The value of their investment as a variable annuity owner will vary depending on the performance of the investment options chosen. 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. The only limitation would be the options offered by the variable annuity and the amount a consumer is willing to put into one position.

In contrast to fixed annuities, "variable" annuities allow individuals to participate in the return of a separate investment account established to fund the annuity contract. There is no minimum guaranteed rate of return and individuals risk losing money, as they would with any investment. An individual's return will reflect the investment experience of the separate account.

Variable annuities enable investment in a selection of funds, called sub-accounts. Available choices range from the most conservative, such as money market, guaranteed fixed accounts, and government bond funds, to more aggressive such as growth, small cap, mid cap, large cap, capital appreciation, aggressive growth, and emerging markets funds. Variable annuities also allow the transfer of money from one account to another without triggering a taxable event. A variable annuity can be an important component of long-term retirement planning because it offers:

- Guaranteed future income that cannot be outlived
- No IRS imposed annual contribution limit on non-qualified money
- Opportunity for growth
- Tax deferral on any growth
- A broad range of investment choices
- Professional investment management
- Tax-free transfers between investment options
- Flexible retirement income options
• Retirement income protection
• Guaranteed death benefit for beneficiaries

The retirement income received from variable annuities depends on the performance of the investment options and the retirement income options selected. Because variable annuities invest in equity markets, they entail more risk than fixed annuities, but they also offer more growth potential. This opportunity for growth may help keep up with or even outpace inflation.

With Variable annuities there are typically two types of investment accounts:

• general (guaranteed) account and
• separate (variable) account.

The variable or separate account offers a variety of subaccounts composed of stocks, bonds and money-market funds with the potential for higher returns but no guarantees. The contract owner determines how much premium is to be allocated to each account, based on his or her investment goals.

Because of the investment risk, variable annuities are legally considered to be securities and must be registered with the Securities and Exchange Commission (SEC) and agents must be both life licensed and registered with the FINRA.

Variable annuities require an agent to have not only a life insurance license, but a variable license and a security license as well. The security license, either a series 6 or series 7, also allows an agent to sell mutual funds.

2. Define fixed annuities

**FIXED ANNUITIES**

In contrast to variable contracts, fixed annuities offer a guaranteed interest rate for a set period of time. The client's earnings grow tax deferred until they begin to withdraw their income. During the accumulation period of a fixed deferred annuity, the client's money (less any applicable charges) earns interest at rates set by the insurance company or in a way spelled out in the annuity contract. The company generally resets the interest rate periodically, but guarantees the rate will never fall below a minimum rate stated in their contract. During the payout period, the amount of each income payment to the client is generally set when the payments start and will not change. Because the principal and interest guarantee is only as good as the company, it is important to consider a strong, stable company that will be there tomorrow.

**Fixed Annuities** are the least risky type of annuities. Interest rates are guaranteed by the insurer for a period of time by the carrier. While interest rates may fluctuate upward or downward over the term, fixed annuities are protected by a guaranteed minimum interest rate over the life of the policy. Fixed annuities may provide seniors with suitable alternatives to other conservative investments, such as certificates of deposit and municipal bonds.

A **fixed annuity** is designed to limit the contract owner's risk, including investment related risk, by providing a guaranteed return. This is accomplished when the insurer invests the annuity premiums in safe, secure investments, which provides a steady, although conservative, interest rate to the contract. This enables the insurer to guarantee the annuity benefit. With a fixed annuity, the values are guaranteed to the contract owner and the insurer assumes the investment risk. The insurer is required to provide the contractually promised values and benefits regardless of its rate of return.

**Fixed annuities** offer:

• **Guaranteed rate of interest.** For an initial period, the insurance company guarantees a fixed rate of interest.
• **Security.** Clients are guaranteed to receive back at least the principal paid into the annuity.

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• **Flexible income options.** A client can choose a lump-sum payment, or equal payments over a specified period, including the rest of their life.

**Fixed annuities** are invested primarily in government securities, and high-grade corporate bonds. They offer a guaranteed rate of return, typically over a period of one to ten years. The company pays for expenses (including commissions) and mortality costs out of the total return on the investments in the general account. They also leave a "spread" for profit.

### 3. Define indexed annuities

**INDEXED ANNUITIES**

Until recently individuals had two choices when it came to annuities: fixed annuities (offering a guaranteed rate) and variable annuities. But in the mid-90s, a third option was introduced and has begun to gain in popularity: the index annuity.

**EQUITY INDEXED ANNUITIES**

**Equity Indexed annuities** are a type of fixed deferred annuity that ties its interest crediting rates to a stock market index, such as, for example the S&P 500. They promise to pay some proportion of amount by which the underlying index has increased, if the index goes up, subject to annual caps.

When a client buys an **equity-indexed annuity** he owns an insurance contract. He is not buying shares of any stock or index.

An **equity-indexed annuity** is different from other **fixed annuities** because of the way it credits interest to your annuity's value. Some fixed annuities only credit interest calculated at a rate set in the contract. Other fixed annuities also credit interest at rates set from time to time by the insurance company. Equity-indexed annuities credit interest using a formula based on changes in the index to which the annuity is linked. The formula decides how the additional interest, if any, is calculated and credited. How much additional interest they get and when they get it depends on the features of their particular annuity.

**Equity-indexed annuities, like fixed annuities,** also promise to pay a minimum interest rate. The rate that will be applied will not be less than this minimum guaranteed rate even if the index-linked interest rate is lower. The value of the annuity also will not drop below a guaranteed minimum. For example, many single premium annuity contracts guarantee the minimum value will never be less than 90 percent of the premium paid, plus at least 3% in annual interest (less any partial withdrawals). The guaranteed value is the minimum amount available during a term for withdrawals, as well as for some annuitizations and death benefits. The insurance company will adjust the value of the annuity at the end of each term to reflect any index increases.

**Equity-Indexed Annuities** combine the minimum interest rate guarantees offered by fixed annuities with the market-linked potential offered by variable annuities to create a product capable of generating market-linked returns without risk to principal. Equity-indexed annuities can be suitable investments for seniors who are willing to accept varying returns but cannot withstand the risk associated with investments like stocks, mutual funds or variable annuities. If the market goes up, the investor is happy because the value of the annuity will increase. If the market goes down, the investor is still happy because the annuity has a guarantee. However, the gain on the index does not include dividends, if any, earned by the companies making up the index.

### 4. Distinguish between the characteristics of fixed, indexed, and variable annuities

**DIFFERENCES BETWEEN FIXED, VARIABLE & EQUITY INDEXED ANNUITIES**

In all three types of annuities the earnings accumulate tax-deferred and can be used to provide lifetime income. The basic difference between fixed and variable annuities is the way each credits earnings to the contract.
FIXED ANNUITIES

- Interest rates are fixed for a stated period of time
- Minimum interest rates are guaranteed for the policy duration
- Once credited, gains are not susceptible to loss in the future
- Principal is not subject to risk

Amounts credited to cash values are based on the insurer’s current declared rate, subject to a minimum guarantee of about 4 percent to 4.5 percent. Rates may be guaranteed for one to five years. The currently declared rate depends on the performance of the insurer’s general investment portfolio or general account, which is largely invested in fixed income investments such as bonds and mortgages. Similar to a savings account, once interest is credited, the cash value will not decline if the market value of the underlying assets in the insurer’s general account declines. The insurer bears the market risk.

VARIABLE ANNUITIES

- Growth or loss based on performance of investment sub-accounts
- Principal as well as previous earnings are subject to risk

The annuity owner may choose to invest in a broad spectrum of separate accounts, which are similar to mutual funds. In contrast with fixed rate annuities, cash values depend on the market value of the underlying assets in the selected separate accounts. Variable annuity owners bear the market risk of investment without minimum interest rate guarantees. However, they have the flexibility to choose their investment portfolio and the potential to earn far greater total returns than on fixed rate annuities.

EQUITY INDEX ANNUITIES

- Interest rates determined by changes in a major market index (i.e. S&P 500)
- Minimum interest rates are guaranteed for the policy duration
- Principal is not subject to risk

EIAs are a recently devised hybrid of fixed and variable annuities. The returns on EIAs are linked to an equity index, such as the S&P 500 index. However, the annuity is not actually invested in the stocks making up the index. Like fixed annuities, the returns to EIAs are paid from the insurance company’s general account. However, the amount allocated to the EIA is based on some percentage of the appreciation in the reference index, subject to annual caps. If the index declines in value, a minimum guaranteed amount is credited to the EIA. In this way, EIAs provide the upside potential of the equity markets with the downside protection of more conservative general account investments.

D. Distinguish the relationship between the annuity types reviewed in A, B, C and how they relate to your client

TYPES OF ANNUITIES

Annuities can be classified in a number of ways.

ACCORDING TO WHEN ANNUITY BENEFIT PAYMENTS BEGIN:

IMMEDIATE ANNUITIES

- The insurance company immediately begins payments for life or for a specified amount of time in exchange for one-time contribution.
- Regular payments can be received on a monthly, quarterly, semiannual or annual basis.
- A portion of each payment represents taxable interest, and the rest is a tax-free return of principal.
DEFERRED ANNUITIES

- Can be funded through a single premium or through flexible payments over time.
- Can help accumulate money for retirement, especially over an extended period of time.
- Money grows tax deferred, which means there are no taxes on earnings until money is withdrawn.

ACCORDING TO HOW AND WHEN PREMIUMS ARE PAID:

SINGLE PREMIUM ANNUITIES

- Can provide a way to turn a large sum of cash into guaranteed income.
- For those who have cash from an inheritance, legal settlement, business sale, etc., can fund an immediate or a deferred annuity.
- For those nearing retirement, who have assets accumulated in a retirement plan or other savings vehicle, can fund an immediate or a deferred annuity.

FLEXIBLE PREMIUM ANNUITIES

- Funded over a period of time, generally years.
- Allow premiums of differing amounts (subject to a stated minimum and maximum) on a set schedule or randomly.
- Assets accumulate on a tax-deferred basis.
- Can fund either fixed or variable deferred annuities.

ACCORDING TO WHERE ASSETS ARE INVESTED:

FIXED ANNUITIES

- Guarantee a specified rate of interest for a specified amount of time.
- Offer preservation of assets and protection from market volatility.

VARIABLE ANNUITIES

- Provide a greater opportunity for asset growth through a variety of investment choices.
- With their greater opportunity for growth, comes greater risk.

INDEXED ANNUITIES

- A hybrid with some characteristics of fixed annuities and some of variable annuities.
- The return is based in part on changes in an index, such as the S&P 500.
- In addition, a minimum interest rate usually is guaranteed.
- Generally include a fixed payment based on the guaranteed interest rate plus a variable payment based on the performance of the applicable equity index.
IV. IDENTIFY THE PARTIES TO AN ANNUITY

PARTIES TO AN ANNUITY CONTRACT

There are four parties to an annuity contract.

- **Insurer** - The insurance company who issues the contract and accepts the premium.
- **Owner** - The owner is the person or, in some cases, the entity that purchases the contract, designates the beneficiary, and holds most of the rights under the contract.
- **Annuitant** - The annuitant is a natural person on whose life income benefits will be based.
- **Beneficiary** - The beneficiary is the person or entity receiving the death benefit.

**STRUCTURING THE ANNUITY CONTRACT**

An annuity is a contract between an annuity owner and an insurance company. However, the contract's rights and benefits are measured by the life of a third party, the annuitant. In addition, disbursement of annuity values which occurs after the death of the contract owner or annuitant goes to the beneficiary. Deciding who to name as the owner, annuitant, and beneficiary of an annuity is commonly referred to as "structuring the contract." Usually, the structure of an annuity contract is kept fairly simple by naming the same individual as both owner and annuitant. If that individual dies, any remaining annuity value is paid to the beneficiary. However, there are situations that call for the annuitant to be someone other than the owner of the annuity. In such cases, agents must take care to ensure that this does not result in unintended consequences. What can complicate the matter is that owner, annuitant, and beneficiary provisions vary somewhat from contract to contract.

For example, under some contracts, the owner would automatically become the annuitant and the annuity would simply continue if the annuitant died while he was still alive. Under other contracts, the value of the annuity would immediately be paid to the beneficiary and the contract would cease upon the annuitant's death regardless of whether the owner was still living. There are other possibilities. Only by reading the contract in question can you determine what rights and benefits pertain to the various parties under a particular annuity. A complex structure may be appropriate in certain cases, but in most situations, the simple contract structure, with its more straightforward control and benefit flow, is the most desirable way to structure the contract.

**A. Describe the rights and obligations of the annuity owner**

**RIGHTS AND OBLIGATIONS OF THE OWNER**

The owner of an annuity enters into the contract with the insurer. It is the owner who makes the premium deposits to buy the contract, and it is the owner who enjoys the tax deferral. As long as the owner is alive, only he or she can control decisions relating to the annuity. These decisions include annuitization, withdrawals, surrenders or changes in designating the annuitant or beneficiary. The owner's death typically triggers a payment of all annuity accumulation value to the beneficiary.

The contract owner generally has the power to do the following:

- Name the annuitant
- Select and change the annuity starting date
- Select and change (prior to the annuity starting date) the payout options
- Name and change the beneficiary
- Request and receive the proceeds of a partial or full surrender
- Initiate and change systematic withdrawals
- Assign or otherwise transfer ownership of the contract to other parties
- Amend the contract with the issuing company’s consent
- Re-allocate proceeds (i.e. variable annuity and equity-indexed annuity)
Some annuity contracts allow the owner to change the annuitant and others do not. If the owner of the contract is not a natural person, a change of annuitant is treated the same as the death of an owner for income tax purposes, which means that certain distributions are required to be made from the contract. Therefore, care should be taken in naming the annuitant when the owner is a nonnatural person in order to avoid unfavorable tax consequences if a change of annuitant is later desired. Under many (but not all) annuities, the owner's rights in the contract cease when the annuitant dies, and one of two things happens: either the value of the annuity is paid to the beneficiary or the beneficiary becomes the new owner. Usually, but not always, the owner and annuitant are the same person. This doesn't present a problem where the owner and the annuitant are the same person. But care must be taken in those situations where the owner and the annuitant are different parties. Under other contracts, the owner's rights do not automatically cease when the annuitant dies. If the owner is not the annuitant and the annuitant dies first, some contracts provide that the owner automatically becomes the annuitant. Other contracts provide for a period of time in which the owner can name a new annuitant, after which, if a new annuitant is not named, the owner becomes the new annuitant. Still other contracts provide for a contingent owner to assume ownership of the contract in the event the original owner dies before the annuitant. In general, it is the owner of the annuity who is taxed on any amounts disbursed from the annuity during the annuitant's lifetime, even if someone else is receiving annuity benefit payments. Naming another person as annuitant does not shift tax liability away from the owner. Only a gift or other transfer of ownership can do that.

**JOINT OWNERSHIP**

There are rules designed to prevent the use of joint ownership to obtain tax deferral on annuity earnings over more than one lifetime, except in the case of married couples. For contracts issued today, there are only a few situations that might call for joint ownership of an annuity. In the case of married couples, the effect of joint ownership for purposes of successor ownership is best obtained by having one spouse be the owner and the other spouse be the beneficiary. In the event of the owner's death, the spouse can succeed to ownership by application of the spousal exception to the required distribution rule.

If joint ownership by a married couple is desirable for other reasons, be sure that each spouse names the other as primary beneficiary for the spousal exception to the required distribution rules to apply, the surviving spouse must be the designated beneficiary of the contract. If someone other than the surviving spouse is the designated beneficiary, then even if the surviving spouse is a joint owner, the spousal exception is lost. With joint ownership of an annuity, the signatures of both owners are required to exercise the rights of ownership. Also, each joint owner assumes the tax liability for one-half of every withdrawal, even if the entire withdrawal was spent by only one of the owners. Any joint owner under age 59½ would also be liable for the 10% penalty tax on any taxable amount of his or her portion of the withdrawal, unless an exception applied. Also joint ownership of IRAs is prohibited by the law governing IRAs.

1. **Identify the entities eligible for annuity ownership**

**ENTITIES ELIGIBLE FOR ANNUITY OWNERSHIP**

Owners in an annuity contract may be a natural person or an entity, such as a corporation or a trust.

The "Non-natural Person" Rule Another special income tax rule that prospective purchasers of annuity contracts should be aware of is the "non-natural person" rule. This provides that a deferred annuity contract held by an owner other than a human being (such as a trust or business entity) will generally not be treated as an annuity for income tax purposes. If the rule applies, the tax deferral feature of the annuity will be lost, and the income earned on the contract will be taxed each year to the contract owner, regardless of whether any distributions from the contract are made. The rule does not apply where the:

- contract is owned by the estate of a deceased annuity owner
- annuity contract is an immediate annuity
- annuity contract is owned by an IRA or a qualified plan of deferred compensation

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• entity owns the annuity as an "agent for a natural person" i.e. certain types of trusts. Any
situation in which trust ownership is proposed for an annuity should be reviewed by a competent
tax professional.

2. Distinguish the rights of the annuity owner in owner-driven contracts

OWNER-DRIVEN CONTRACTS

Annuity carriers may structure an annuity contract as owner-driven or annuitant-driven

In owner-driven annuity contracts, benefits are based upon something happening to the owner (death, disability, reaching a certain age, etc). Owners have all legal rights, and can change, as needed, the designated annuitant, as the contract specifies, without any negative tax or penalties. Owner-driven contracts pay out only on death of the owner.

Under an owner-driven contract, the annuity remains in force if the annuitant dies. The owner must name a new annuitant, or the contract may specify that the owner also becomes the annuitant. If there is a contingent annuitant, then the contingent annuitant becomes the annuitant; the owner typically may not name a new contingent annuitant. However, if it is a contingent annuitant who dies, not the primary annuitant, the owner may simply name a new contingent annuitant.

In owner-driven contracts where the owner is a natural person, the owner's right in the contract dissolves upon the owner's death. In an owner-driven contract, the owner has the right to name a new annuitant. In owner-driven contracts where the owner is a corporation or nonnatural person, the primary annuitant is treated as the owner. Under these circumstances, death of the annuitant would trigger a distribution from the contract.

3. Distinguish the rights of the annuity owner in annuitant-driven contracts

ANNUITANT-DRIVEN CONTRACTS

In annuitant-driven contracts, the owner's rights dissolve upon the death of the annuitant.

Annuitant-driven contracts base benefits on something happening to the annuitant (death, disability, reaching a certain age, etc). These annuities typically spell out that owner(s) can be changed and are contract-specific as to whether or not an annuitant can be changed once the contract is issued. Further, upon the death of either owner(s) or annuitant(s), the contract will pay out.

B. Describe the rights and obligations of the annuitant

RIGHTS AND OBLIGATIONS OF THE ANNUITANT

The annuitant's obligations within an annuity contract are very limited. In most annuity contracts the annuitant is the individual who will receive the income benefits under the contract. It is the annuitant's life expectancy which determines the benefits payable under an annuity. And it is the attainment of a given age on the part of the annuitant that triggers the annuity starting date under an annuity. The benefits themselves may actually be paid to a different party. Some contracts allow joint annuitants, however, this may unnecessarily increase the risk that unwanted changes will be made to the contract prior to the annuity starting date. The increased risk of naming joint annuitants may be unnecessary because a joint-and-survivor income option can be chosen if a guaranteed lifetime income stream over the lives of two individuals is desired. It is generally the owner rather than the annuitant who is taxed on annuity payments. If the owner and the annuitant are the same person, of course, it is the owner/annuitant who is taxed. However it is with reference to the annuitant's life that the exclusion ratio for the payment is calculated. Also, some contracts provide that the annuitant will become the owner of the contract after annuitization. In that case, the annuitant, as owner, would become liable for the tax on the income-taxable portion of those payments.
1. Identify the entities eligible for the role of annuitant

THE ENTITIES ELIGIBLE FOR THE ROLE OF ANNUITANT

The annuitant must be an individual (or in the case of joint annuitants, two individuals). If a trust, corporation, or other nonnatural person were the annuitant, there would be no natural life by which to measure the benefits of the contract. The annuitant and the owner do not have to be the same.

2. Distinguish the role of annuitant in owner-driven contracts

THE ROLE OF ANNUITANT IN OWNER-DRIVEN CONTRACTS

In owner-driven contracts, the role of the annuitant is to establish the income benefits at the time of annuitization.

3. Distinguish the role of annuitant in annuitant-driven contracts

THE ROLE OF ANNUITANT IN ANNUITANT-DRIVEN CONTRACTS

While the same is true of an annuitant-driven contract, the annuitant's death also triggers a distribution from the contract, payable to the designated beneficiary, and all of the owner's rights dissolve.

C. Describe the rights and obligations of the insurance company (Section 10127.10, 10127.11, 10127.12, 10127.13, and 10509.6 of the CIC)

RIGHTS AND OBLIGATIONS OF THE INSURANCE COMPANY

Insurance companies have responsibilities to policyholders, agents, investors, and insurance regulators including:

To Manage Investments

For the benefit of its policyholders, agents, and investors, an insurance company must manage its investment portfolio wisely.

To Administer Contract Provisions and Benefits

When a consumer purchases an annuity, the insurer assumes a duty to administer the benefits and provisions of the contract indefinitely.

To Comply With California Insurance Code

Insurers who offer annuities in California have specific obligations as referenced in selected Sections in California's Insurance Code; some apply to seniors while others apply to all consumers.

Insurance companies acquire many obligations and duties in the sale of an annuity. In California, there are also sweeping new guidelines (CIC 10127, 10509.6) that specifically address sales to senior citizens (an individual who is 60 years of age or older on the date of purchase). Many of these rules directly affect agents so we will discuss them in some detail:

10127.10

FREE-LOOK PERIOD

This Section of the Code has two critical requirements for insurers as it relates to people 60 years and older.
• First, it requires that all insurers clearly state the **30-day free-look** period on the policy cover or policy jacket in 12-point bold print.

• Second, for purchasers of **variable annuities**, insurers are required to provide additional language, stating, *“funds during the 30-day free-look have been invested in a fixed account or money market fund. If the owner directs the premium to be invested into the variable annuity’s subaccounts immediately, they are no longer guaranteed a full return of their premium.”* (Ref. 10127.10 of CIC)

10127.11

**ILLUSTRATIONS**

Illustrations after 1/1/2005 must have a printed and prominently displayed disclaimer about financial performance. Consumers need to have all the financial facts, both good and bad, so that they can make the best decision for themselves based on having the full picture of what they are buying and how it will perform; both in the short and longer term.

Like agents, insurers who generate illustrations that contain values that are not guaranteed must contain the same disclosure as agents (Section 10127.11 of CIC) Insurers have requirements when replacement is involved.

• Require all agents to comply with replacement regulations
• Notify existing insurer of proposed replacement
• Maintain replacement records for three years
• Include with the policy a notice informing the policy owner of the free-look provision.

Every **insurer and life agent** offering for sale individual life insurance policies or individual annuity contracts that are initially delivered or issued for delivery to **senior citizens** in this state **on and after January 1, 1995**, with the use of non-preprinted illustrations of non-guaranteed values shall disclose on those illustrations or on an attached cover sheet, in bold or underlined capitalized print, or in the form of a contrasting color sticker, bright highlighter pen, or in any manner that makes it more prominent than the surrounding material, with at least one-half inch space on all four sides, 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.”**

All preprinted policy illustrations shall contain this notice in 12-point bold print with at least one-half inch space on all four sides and shall be 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 non-guaranteed 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**.

10127.12

**ANNUAL STATEMENTS**

Whenever an insurer provides an annual statement to a policyowner 60 years and older of an annuity contract issued after 1/1/95, the insurer is required to provide both the current accumulation value and the current cash surrender value.

An insurance company must inform each annuity owner of their **accumulation value** and the current **cash surrender value** of their annuity contracts **at least once a year** on the annual statement provided to each annuity holder.

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10127.13

DISCLOSURE OF SURRENDER CHARGES

All individual life insurance policies and individual annuity contracts for senior citizens that contain a surrender charge period shall either 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.

If an annuity contains surrender fees and a surrender fee period, it is important for the annuity owner to have been made aware of this fact at the time of the sale by the agent. To make double sure that the client is aware, California requires that the insurance company disclose this, as well, on the cover sheet of the annuity contract in large print.

Especially for seniors age 60 and over any surrender fees required at that time would dilute the amount of money that was planned on for their retirement.

10509.6

REPLACEMENT

Companies and agents must also follow very specific timed procedures when replacing another company’s annuity. And, the company whose policy is being replaced must follow specific timed responses to their client and the replacing company.

- When accepting an application for an annuity contract, agents must now sign and have their client(s) sign a statement as to whether a replacement of an existing annuity or life contract is involved.
- If a replacement is involved, agents must get their client to sign, at the time of application, a special disclosure form identifying the replaced annuity with a special statement regarding the potential consequences of a replacement contract.

Every insurer that uses an agent in an annuity sale must, as part of each completed application, require 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 insurance company must:

- Require from the agent with the application for life insurance or annuity:
  - a list of all of the applicant's existing life insurance or annuity to be replaced, and
  - a copy of the replacement notice must be provided the applicant. An existing annuity shall be identified by name of insurer, insured, and contract number. If a number has not been assigned by the existing insurer, alternative identification, such as an application or receipt number shall be listed.
- Send to each existing 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 shall 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 insurer or the insurer's agent that undertakes a conservation shall, within 20 days from the date the written communication plus the materials required in subdivisions (1) and (2) 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 shall be maintained for at least three years.
- The replacing insurer shall 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 shall entitle the owner to a refund of account value and any policy fee paid for the policy. The account value 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.

Cost indices and equivalent level annual dividend figures need not be included in the policy summary or ledger statement. This written communication shall 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 the written communication plus the materials required in subdivisions (1) and (2) 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 shall be maintained for at least three years.
- The replacing insurer shall 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 shall entitle the owner to a refund of account value and any policy fee paid for the policy. The account value 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.
Section 10509.916:

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 must take reasonably appropriate corrective action for any consumer harmed by the insurer’s, 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.

1. Distinguish obligations with insurance company issued non-qualified annuities

NON-QUALIFIED ANNUITY CONTRACTS MAY REQUIRE THE INSURER TO ADMINISTER THE FOLLOWING:

- Flexible deposits
- Systematic withdrawals
- Policy owner changes
- Partial and full surrenders
- Annual statements
- Re-allocating interest strategies
- Annuitzation benefits
- Distributions upon death
- Tax reporting of non-death distributions
- Tax reporting of death benefit distributions
- Income tax withholding for Non-qualified stretch benefits withdrawals, death benefits, and annuitization options
- Policy cancellations and refunds

2. Distinguish obligations with insurance company issued annuities for individual retirement accounts, tax sheltered annuities, and qualified retirement plans

QUALIFIED ANNUITY CONTRACTS MAY REQUIRE THE INSURER TO ADMINISTER THE FOLLOWING:

- Minimum Required Distributions
- IRS reporting requirements of qualified contributions
- IRS reporting requirements of qualified rollovers
- IRS reporting requirements for 10% excise tax on early distributions
- Stretch IRA benefits

3. Introduce insurance rating services and how they indicate an insurer’s financial strength

COMPANY FINANCIAL STABILITY & RATING SERVICES

Another concern in recommending the right product is the financial stability of the company issuing the annuity. When it comes to annuities, many agents put too much weight on product features and not enough on the insurer’s financial strength and stability. An annuity policy is only as secure as the company issuing it. There are a number of independent rating services to help you and your clients
evaluate an insurance company’s financial strength and stability. No rating provides an absolute guarantee of continued solvency, but the ratings do offer an expert, informed opinion about a company’s financial condition based on a thorough analysis of the company’s circumstances. The major rating services for insurance companies are:

- A. M. Best Company
- Standard & Poor's
- Duff & Phelps
- Weiss Research
- Moody's Investors Service

**The A.M. Best Company:**

A.M. Best is perhaps the best known of all the insurance rating companies. It publishes over 50 different information products about insurance companies and the insurance industry. Here is an overview of what the A.M. Best rating system means.

**The following ratings are considered “secure” ratings by A.M. BEST:**

- **A++ and A+ (Superior):** The company has demonstrated superior overall performance and has a very strong ability to meet its obligations to policyholders over a long period of time.
- **A and A- (Excellent):** The company has demonstrated excellent overall performance and has a strong ability to meet its obligations to policyholders over a long period of time.
- **B++ and B+ (Very Good):** The company has demonstrated very good overall performance and has a good ability to meet its obligations to policyholders over a long period of time.

**The following ratings indicate that a company is “vulnerable” to financial difficulties in the future by A. M. BEST:**

- **B and B- (Adequate):** The company has an adequate overall performance and can meet its obligations to policyholders, but may be vulnerable to unfavorable changes in underwriting or economic conditions. **C++ and C+ (Fair):** The company has demonstrated fair overall performance and can meet its current obligations to policyholders, but is vulnerable to unfavorable changes in underwriting or economic conditions.
- **C and C- (Marginal):** The company has demonstrated marginal overall performance. It can meet its current obligations to policyholders, but it is very vulnerable to unfavorable changes in underwriting or economic conditions.
- **D (Very Vulnerable):** The company has demonstrated poor overall performance. The company can meet its obligations to policyholders, but is extremely vulnerable to unfavorable changes in underwriting or economic conditions.
- **E (Under State Supervision):** The company is under state insurance regulatory authority supervision, control or restraint, such as conservatorship or rehabilitation, but not including liquidation. This rating may be assigned if the company is under a cease and desist order issued by a state regulator other than from its state of domicile.
- **F (In Liquidation):** The company has been placed under an order of liquidation by a court of law, or its owners have voluntarily agreed to liquidate. Companies that voluntarily liquidate or dissolve their charters are generally not insolvent.

**Standard & Poor’s:**

Standard and Poor's rates the claims-paying ability of over 300 insurance organizations worldwide, and monitors public data on another 2,000 U.S. companies.
The following ratings are considered "secure" ratings by Standard & Poor's:

- **AAA** Superior financial security on an absolute and relative basis. Capacity to meet policyholder obligations is overwhelming under a variety of economic and underwriting conditions.
- **AA** Excellent financial security. Capacity to meet policyholder obligations is strong under a variety of economic and underwriting conditions. Good financial security, but capacity to meet policyholder obligations is somewhat susceptible to adverse economic and underwriting conditions.
- **BBB** Adequate financial security, but capacity to meet policyholder obligations is susceptible to adverse economic and underwriting conditions.

The following ratings are considered "vulnerable" ratings by Standard & Poor's:

- **BB** Financial security may be adequate, but capacity to meet policyholder obligations, particularly with respect to long-term or "long-tail" policies, is vulnerable to adverse economic and underwriting conditions.
- **B** Vulnerable financial security. Currently able to meet policyholder obligations, but capacity to meet policyholder obligations is particularly vulnerable to adverse economic and underwriting conditions.
- **CCC** Extremely vulnerable financial security. Continued capacity to meet policyholder obligations is highly questionable unless favorable economic and underwriting conditions prevail.
- **R** Regulatory action. As of the date indicated, the insurer is under supervision of insurance regulators following rehabilitation, receivership, liquidation, or any other action that reflects regulatory concern about the insurer's financial condition. Information on this status is provided by the National Association of Insurance Commissioners and other regulatory bodies. Although believed to be accurate, this information is not guaranteed. The "R" rating does not apply to insurers subject only to non financial actions such as market conduct violations.
- **NR** Not Rated. The insurer is not rated by Standard & Poor's. Plus (+) or Minus (-) sign

The ratings from "AA" to "B" may be modified by the addition of a plus or minus sign to show relative standing within the major rating categories. Standard & Poor's ratings and other assessments of creditworthiness and financial strength are not a recommendation to purchase or discontinue any policy or contract issues by an insurer or to buy, hold or sell any security issued by an insurer. In addition, neither a rating nor an assessment is a guaranty of an insurer's financial strength.

**Moody's:**

Moody's Ratings, founded in 1909, rates the financial strength of a variety of investment vehicles and institutions, including corporate bonds, preferred stock, short-term debt, mutual funds and insurance companies.

The following ratings are considered "strong" by Moody's:

- **Aaa** Exceptional financial security. While the financial strength of these companies is likely to change, such changes as can be visualized are most unlikely to impair their fundamentally strong position.
- **Aa** Excellent financial security, together with the Aaa group, they constitute what are generally known as high-grade companies. They are rated lower than Aaa companies because long-term risks appear somewhat larger.
- **A** Good financial security. However, elements may be present which suggest a susceptibility to impairment sometime in their future.
- **Baa** Adequate financial security. However, certain protective elements may be lacking or may be characteristically unreliable over any great length of time.
The following ratings are considered “weak” by Moody’s:

- **Ba** Questionable financial security. Often the ability of these companies to meet policyholder obligations may be very moderate and thereby not well safeguarded in the future.
- **B** Poor financial security. Assurance of punctual payment of policyholder obligations over any long period of time is small.
- **Caa** Very poor financial security. They may be in default on their policyholder obligations or there may be present elements of danger with respect to punctual payment of policyholder obligations claims.
- **Ca** Extremely poor financial security. Such companies are often in default on their policyholder obligations or have other marked shortcomings.
- **C** The lowest rated class of insurance company; can be regarded as having extremely poor prospects of ever offering financial security.

1, 2, 3 Modifiers for each generic rating category from Aa to B. 1 indicates that the insurance company ranks in the higher end of its generic rating category. The modifier 2 indicates a mid-range ranking. The modifier 3 indicates that the company ranks in the lower end of its generic category.

4. Advertising responsibilities (Section 787 of the CIC)

**ADVERTISING FOR PERSONS 65 YEARS AND OLDER (SECTION 787 ET SEQ. OF THE CIC)**

SB 620 requires agents to adhere to strict guidelines when advertising to senior citizens. These provisions of the Code better protect seniors from misleading, deceptive, or confusing advertising practices. The new law includes several measures to prevent misleading advertisements, including advertisements that imply incorrectly that a particular insurer or insurance product is endorsed by any governmental agencies, non-profit or charitable organizations.

Any advertisement or other device designed to produce leads based on a response from a potential insured which is directed towards persons age 65 or older shall prominently disclose that an agent may contact the applicant. Further, agents who make contact with a person as a result of acquiring that person's name from a lead generating device shall disclose that fact in the initial contact with the person.

Additionally, no insurer, agent, broker, solicitor, or other person or other entity is allowed to solicit persons age 65 and older in this state for the purchase of 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.

**DEFINITION OF ADVERTISEMENT: ENVELOPES, STATIONARY, BUSINESS CARDS (SECTION 787(k) OF THE CIC)**

Advertising to seniors includes envelopes, stationery, business cards, or other materials designed to describe and encourage the purchase an annuity.

Examples of misleading advertising 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.
- No advertisement may use the name of a state or political subdivision thereof in a policy name or description.
- No advertisement may use any name, service mark, slogan, symbol, or any device in any manner that implies that the insurer, or the policy or certificate advertised, or that any agency who may
call upon the consumer in response to the advertisement, is connected with a governmental agency, such as the Social Security Administration.

- No advertisement may imply that the reader may lose a right, or privilege, or benefits under federal, state, or local law if he or she fails to respond to the advertisement.
- An insurer, agent, broker, or other entity may not use 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.
- No insurer may use, in the trade name of its insurance policy or certificate, 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.
- And, no insurer, agent, broker, or other entity may solicit a particular class by use of advertisements which state or imply that the occupational or other status as members of the class entitles them to reduced rates on a group or other basis when, in fact, the policy or certificate being advertised is sold on an individual basis at regular rates.

All advertisements used by agents, producers, brokers, solicitors, or other persons for a policy of an insurer must have written approval of the insurer before they may be used.

Relating to any Government Agencies (Section 787 of the CIC)

There are a number of other things that cannot be used to deceive consumers.

- Agents must also know that “advertisements must not employ words, letters, initials, symbols, or other devices which 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.”
- An advertiser can’t suggest that their name is connected with or endorsed by governmental agencies, nonprofits, charitable institutions, or senior organizations.
- Advertisements, coverages, and advertisers may not in any way imply a product is endorsed by or related to any government agencies.
- Advertised coverages cannot appear as if they are somehow provided by or endorsed by any governmental agencies, non-profits, charitable institutions, or senior organizations.
- No advertisement may use any name, service mark, slogan, symbol, or any device in any manner that implies that the insurer, the policy, the certificate advertised, or the agency is connected with a governmental agency, such as the Social Security Administration.
- In addition, no advertisement may use the name of a state or political subdivision in a policy name or description.

5. Policy cancellation and refunds (Section 786, 10127.10, and 10509.6 of the CIC)

CANCELLATIONS AND REFUNDS (CIC 786, 10127.10, 10509.6)

If a policy owner elects to cancel the contract within 30 days of the delivery date, insurers are required to provide an unconditional refund of all premiums and policy fees. All such refunds must be made no later than 30 days after the insurer or the issuing entity receives the returned contract. In the event a refund exceeds the 30-day allowance, the owner is entitled to interest on premiums paid. (Sections 786, 10127.10, 10509.6 of CIC)

AGENT’S RESPONSIBILITY TO COMPLY WITH REPLACEMENT GUIDELINES (CIC 10509.4 AND 10509.8)

Insurance Company Obligations – Replacement

Companies and agents must also follow very specific timed procedures when replacing another company’s annuity. And, the company whose policy is being replaced must follow specific timed responses to their client and the replacing company. This provides timely response regarding the
replacement for the annuity purchaser’s benefit and protection that the replacement was in the client’s best interest.

**CIC.10509.6** Every life insurer that uses an agent in a life insurance or annuity sale shall do the following:

- Require with or as 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 require from the agent with the application for life insurance or annuity:
  - 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. The existing life insurance or annuity shall be identified by name of insurer, insured, and contract number. If a number has not been assigned by the existing insurer, alternative identification, such as an application or receipt number shall be listed.

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 shall 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 the written communication plus the materials required in subdivisions (1) and (2) 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 shall be maintained for at least three years.
- The replacing insurer shall 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 shall entitle the owner to a refund of account value and any policy fee paid for the policy. The account value 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.

The exchange of one annuity for another has come under considerable scrutiny and criticism in recent years based on questionable suitability of some of the exchanges. Studies show that a large percentage
of the annuities sold replaced previous annuities. Regulators are concerned with inappropriate “churning” of annuities which are designed to be held long-term.

According to statistics compiled by the National Association of Variable Annuities during the calendar year 2002, approximately $113.7 billion in variable annuity (VA) sales was recorded by the 25 largest annuity writers in the United States (source: NAVA Outlook, March/April 2003). Of this sum, NAVA estimated that close to 73 percent of sales during 2002 were exchanges from one product to another.

In California, life agents who replace annuities or life insurance with new annuities have certain basic responsibilities that apply to the general population. (Section 10509.4) When an agent takes an application for an annuity, a statement must be provided to the insurer signed by both the agent and the applicant indicating whether replacement of an existing annuity or life insurance contract is involved. In the event replacement is involved, the agent has the following additional requirements:

- Present the applicant with the Notice Regarding Replacement at the time the application is taken. The Notice Regarding Replacement must:
  - List all existing life insurance and annuity contracts to be replaced
  - Properly identify the insurer, contract number(s), and insured/owner
  - Be signed by both agent and applicant
- Leave the Notice Regarding Replacement with the applicant;
- Leave the applicant with a copy of all printed communications used during the presentation;
- Provide the replacing insurer with a copy of the completed Notice Regarding Replacement with the application.

### 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 ______________________________

Agents who are attempting to conserve a replacement, (Section 10509.4 of CIC) must leave any written or printed communications used to conserve the business with the applicant. Under Section 10509.8 of the California Insurance Code, a violation occurs if an agent recommends the replacement of an existing annuity when an inaccurate presentation or comparison of premiums, benefits, dividends and values are made. Agents must evaluate the replacement on the basis of whether all of these aspects are equal to or better than the existing annuity.

The State Of California is also concerned with annuities which are replaced unnecessarily. New definitions for "unnecessary replacement" contained in Section 10509.8 of the California Insurance Code and apply to anyone who is 65 year of age or older.

"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. Agents must be much more careful when working with
replacements. Since stiffer fines for violations also went into affect agents are advised to keep good
records to support recommendations involving replacements.

FREE LOOK EXAMINATION PERIOD

Agents should know that clients over age 60, as well as persons younger than 60, who purchase
annuities must now be given the right to cancel them within 30 days (786, 10127.9, 10127.10 CIC). This
law, which supersedes similar legislation defining seniors as 65 years, applies to all contracts sold and
delivered after 1/1/04. Return of the policy during the cancellation period has the effect of voiding the
policy from the beginning and placing the parties in the same position as if no policy had been issued.
That means that all premiums and policy fees shall be refunded by the insurer. 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.

AGENT'S RESPONSIBILITY REGARDING THE FREE-LOOK PERIOD (CIC 786 & 10127.1)

Under Sections 786 and 10127.10 of CIC, annuity contracts issued to people age 60 and older must
contain a free-look provision which allows the buyer a period of 30 days after purchase to return the
contract and receive a full refund of premiums paid. No interest is paid on the premium in the event the
contract owner returns the contract for a refund. Agents have the following responsibilities:

- To deliver the annuity contract in a timely fashion.
- Obtain a Notice of Delivery signed by the contract owner, and return it to the insurer in a timely
  fashion.
- Thoroughly explain the 30-day free-look provision when delivering the contract.

SAMPLE OF A NOTICE FOR FIXED ANNUITY CONTRACTS

<table>
<thead>
<tr>
<th>IMPORTANT</th>
</tr>
</thead>
<tbody>
<tr>
<td>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.</td>
</tr>
</tbody>
</table>

The phrase “after 30 days, cancellation may result in a substantial penalty, known as a surrender charge” may be omitted if the policy does not contain a surrender charge or other penalty.

With a fixed annuity, the “free look” provision, also called the right-to-examine or right-to-cancel provision, is fairly straightforward. The owner is given a period of time beginning with the date on which the contract is delivered to change his or her mind. If the owner returns the contract, he or she is given a full refund of any premium paid. No surrender charges or other fees are deducted from the amount refunded.

SAMPLE OF A NOTICE FOR VARIABLE ANNUITY CONTRACTS

<table>
<thead>
<tr>
<th>IMPORTANT</th>
</tr>
</thead>
<tbody>
<tr>
<td>YOU HAVE PURCHASED A VARIABLE ANNUITY CONTRACT. CAREFULLY REVIEW IT FOR LIMITATIONS.</td>
</tr>
<tr>
<td>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</td>
</tr>
</tbody>
</table>

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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 situation is not as simple with a variable annuity. Most variable annuities provide for immediate allocation of the premium according to the owner's instructions. In such cases, the contract generally provides that the amount subject to refund during the free look period will be based on the value of the investment options in the separate account (plus any charges deducted before the premium was credited to the separate account) rather than the premium paid. Otherwise, if investment experience were poor during the free look period, annuity owners could recoup their losses simply by returning the contract.

Section 10127.10 of the California Insurance Code also includes new free-look language from Senate Bill 620, applicable to people age 60 and older who purchase a variable annuity. All premiums paid for a variable annuity must be allocated to fixed-income investments and money market funds during the free-look. This assures that all premiums paid will be refunded during the free-look period if the senior has a change of mind or circumstances. The investor may, however, direct the premium be invested into the variable annuity's subaccounts immediately, in which case, the senior is no longer guaranteed a full return of their premium.

D. Describe the rights of and options available to beneficiaries

Similar to the notice for fixed annuities, the notice that must accompany variable annuities may omit the phrase "known as a surrender charge" if the annuity contract does not contain surrender charges.

1. Identify how beneficiaries may be affected by SB 483

HOW SENATE BILL 483 AFFECTS BENEFICIARIES:

The state would become a beneficiary for an annuity in order to replay loss incurred from medical and living expenses incurred by the individual by the state, the bill reads: “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.”

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The benefits of an annuity are designed to flow primarily to the owner and annuitant. Rights of the beneficiary begin only after the death of either the owner or the annuitant, depending on whether the contract is owner-driven or annuitant-driven. While it is the owner who is taxed on an annuity during the annuitant's life, upon the annuitant's death it is the beneficiary who becomes liable for income tax on any gain paid out of the contract. Also, in some cases, the beneficiary may become liable for the 10% penalty tax on premature distributions because of the way the definition of "premature distribution" is written in the tax law for annuities purchased on a nonqualified basis. The 10% premature distribution penalty tax rule for qualified plans, would allow any beneficiary to avoid the penalty tax in the event of the annuitant's death. Therefore, if an annuity is purchased on a nonqualified basis and the owner of the annuity is a natural person and is not the annuitant, the annuitant's beneficiary will be liable for the 10% penalty tax if he or she receives taxable death proceeds from the annuity when he or she is under age 59½.

The beneficiary in an annuity may be a natural person or an entity, such as a trust. More than one beneficiary can be named under an annuity. Most annuities provide that if more than one beneficiary is named, equal shares will be paid to each beneficiary unless the owner has specified otherwise. In most cases, the beneficiary is the owner's spouse so that the spousal exception to the required distribution rules can be used to continue the contract in the event of the owner's death. Sometimes it is appropriate for the owner to name his or her child or children as beneficiaries. If a beneficiary is a minor child, the owner should have a will and name a guardian to receive the benefits on the child's behalf. Otherwise, the child's lack of legal competence will likely cause the insurer to delay paying the benefits until a guardian is appointed by a court.

In a few cases, it may be appropriate to name a trust or estate beneficiary under an annuity. If the proceeds are paid to a nonnatural person as a required distribution upon the owner's death prior to the annuity starting date, proceeds must be distributed within five years. The annuitization option will not be available, since the beneficiary is not a natural person. Most annuities reserve the contract owner's right to change the beneficiary at any time during the annuitant's life. However, some contracts give the owner the option of naming a permanent, or irrevocable, beneficiary. If an irrevocable beneficiary is named, the beneficiary designation can later be changed only with the beneficiary's consent.

2. Discuss the settlement options available to beneficiaries

SETTLEMENT OPTIONS AVAILABLE TO THE BENEFICIARY

Settlement options for the beneficiary after the death of either the owner or the annuitant, depends on whether the contract is owner-driven or annuitant-driven. Agents should carefully structure the contract so the contract owner’s expectations will be met.

The options to beneficiaries are addressed in Section 72 of the Internal Revenue Code (IRC) and are generally based on one of three beneficiary types:

- Primary beneficiary is a surviving spouse; or
- Primary beneficiary is an individual other than a surviving spouse; or
- Primary beneficiary is an entity.

a. As a Surviving Spouse

PRIMARY BENEFICIARY IS SURVIVING SPOUSE

If the beneficiary is designated as the surviving spouse, the beneficiary has the following settlement options:
• Assume ownership and continue the contract; or
• Take the proceeds as a lump sum distribution no later than the end of the calendar year following
  the year which death occurs; or
• Take the proceeds by the end of the calendar year containing the fifth anniversary of death; or
• Take the proceeds over the beneficiary's life expectancy with payments beginning no later than
  the end of the calendar year following the year which death occurs

<table>
<thead>
<tr>
<th>b. As an individual or an entity other than a surviving spouse</th>
</tr>
</thead>
</table>

**PRIMARY BENEFICIARY IS AN INDIVIDUAL OTHER THAN A SURVIVING SPOUSE**

If the beneficiary is designated as an individual other than a surviving spouse, the beneficiary has the
following settlement options:

• Take the proceeds as a lump sum distribution no later than the end of the calendar year following
  the year which death occurs; or
• Take the proceeds by the end of the calendar year containing the fifth anniversary of death; or
• Take the proceeds over the beneficiary's life expectancy with payments beginning no later than
  the end of the calendar year following the year which death occurs

**PRIMARY BENEFICIARY IS ENTITY**

If the beneficiary is designated as an entity (such as a corporation or trust), the beneficiary has the
following settlement options:

• Take the proceeds as a lump sum distribution no later than the end of the calendar year following
  the year which death occurs; or
• Take the proceeds by the end of the calendar year containing the fifth anniversary of death

Most insurance companies allow death benefits to be paid as a lump sum, however. Some annuities
require a five-year distribution with these contracts, carriers will assess surrender charges if the
beneficiary takes a lump sum distribution.
V. HOW FIXED, VARIABLE, AND INDEX ANNUITY CONTRACT PROVISIONS AFFECT CONSUMERS 15%

ANNUITY CONTRACT PROVISIONS

A. Identify and discuss contract provisions that are typically common to annuities

PROVISIONS COMMON TO MOST ANNUITIES

While each annuity described has its own unique characteristics, certain provisions are common to all contracts. This section covers the provisions commonly found among all annuities, after which we will look at those specific to fixed, equity-indexed and variable annuity contracts.

Interest Rates and Compensation

Insurers have several ways of crediting (paying) interest on the funds in an annuity. All insurance companies provide their contract owners with annual statements that contain basic information relative to account values and transactions. Some insurers prepare this accounting at the end of each contract year, and some do so at the end of each calendar year. Regardless of when a statement is prepared, it provides information on all activity within that account during the year.

1. Issues ages (Section 10112 of the CIC)

ISSUE AGE PROVISIONS (Section 10112 of the CIC)

There is no specific California law governing the maximum issue ages for annuities, and most insurers will issue an annuity contract up to age 85 or even older.

There are, however, rules relating to minimum issue ages. In California, a person younger than 18 years of age is a minor. Under provisions of California Probate Code and California Insurance Code (Section 10112), a minor does not have the right to contract for life or disability insurance or annuity contracts. The California Uniform Transfer to Minors Act (UTMA) allows minors to own investments and other types of property. A donor appoints a custodian and irrevocably gifts money to a trust. The property then legally belongs to the minor but is controlled by the custodian until the minor reaches the age of 18 (which may be extended to a maximum age of 25) (California Probate Code, Section 3920.5). Agents should consult their insurer when minors are involved.

2. Maximum ages for benefits to begin

MAXIMUM AGE FOR BENEFITS TO BEGIN

Most companies generally require that annuitants be under the age of 75 when the contract is initially signed. Others allow a range up to age 90. Benefits are trigged when something happens to an annuitant or owner. However, some contracts require distribution or an orderly liquidation once the annuitant reaches a certain age, typically 80 or 85.

Every deferred annuity contract specifies a maturity date or annuity date, which is the date on which annuitized payments are scheduled to begin. A contract's maturity date usually is the later of 10 contract years or the contract anniversary that falls in the year the annuitant reaches age 85. (In some contracts, the maturity age is 100.) Most insurers allow a contract owner/annuitant to continue the deferral period for some time past the maturity date or annuitize the contract before the maturity date. Typically, an annuity contract provides the insurer has a right to require proof that the annuitant is living on the date of any annuity payment.
**STRETCH PROVISIONS FOR QUALIFIED ANNUITIES**

In January, 2001 the IRS issued new rules governing the distribution phase of IRAs. One of the features of the new 2001 rules is that IRA owners are now permitted to take smaller **Minimum Required Distributions (MRD)**.

Under the old rules, **Individual Retirement Accounts (IRAs)** were created to let individuals use the advantage of tax deferral to accumulate funds for retirement until they reached the age of 70½. At that point, individuals were required by law to begin withdrawing funds annually because the IRS wanted them to withdraw all of their money and pay all of the taxes before they died. And if a person did not take distributions or if the amount distributed was not large enough, he or she faced a severe tax penalty equal to 50% of the amount by which the required minimum distribution amount exceeded the actual amount distributed. And to make matters worse, the amount of the required minimum distributions increased annually. So not only must they pay taxes on increasing distributions they do not need, but the benefits of future tax deferral and compounding on the amount distributed was also lost.

Under the old rules the distribution from an inherited IRA had to be withdrawn by the beneficiary over a period no greater than five years. New tables allow individuals to take smaller distributions each year, thereby maintaining tax-deferred compounding of the balance. Beneficiaries may continue distributions based on their own individual life expectancies.

Under the new rules, each beneficiary of an inherited IRA is entitled to "**stretch**" out the inherited IRA distribution over their individual life expectancy. By stretching the death benefits over the course of the beneficiary's life expectancy, the amount remaining in the IRA can continue to benefit from tax-deferred growth. Also the beneficiary can lower the tax by lengthening the distribution period. The new rules also apply to annuities used in qualified plans.

Under the new rules, the age of a spouse beneficiary determines which IRS table is used to determine the owner’s required minimum distribution amounts. If the spouse is **less than 10 years younger** (as with most beneficiaries), the owner uses the Uniform Lifetime Table, and his or her payment amounts are based on his or her sole life expectancy. If the spouse beneficiary is **more than 10 years younger**, however, the owner uses the **Joint Life Expectancy Table** to determine the applicable life expectancy factor which results in smaller annual distributions. If the annuity owner dies before his or her spouse beneficiary, the spouse can assume ownership of the annuity and begin new minimum distributions based on his or her own age. This Spousal Rollover option stretches the income over a longer distribution period, and provides an income stream, increased independence and security for the spouse. Taking advantage of the new rules to stretch annuity distributions over time is not for everyone, but if clients already have all the income they need to maintain their lifestyle and they want to take advantage of tax-deferred growth and compounding to pass greater wealth on to loved ones, they may want to learn more about how the new rules can work for them.

**STRETCH PROVISIONS FOR NON-QUALIFIED ANNUITIES**

With some exceptions, Internal Revenue Code allows the death benefit from a nonqualified annuity to be extended over the beneficiary's life expectancy as calculated by the "**uniform table**" used for determining MRD regulations. By electing a "**non-qualified annuity stretch**":

- The income will be less than the income using life only annuitization settlement.
- Because life expectancies of the "uniform table" are longer than standard mortality tables.
- The beneficiary maintains the tax-deferred status on the unpaid death benefit.
- Under an annuitization option, funds no longer benefit from tax-deferral.

The new rules establish **much smaller** required minimum distributions and allow individuals to maintain and maximize the benefits of their annuity by making it possible to "**stretch**" those mandatory distributions over the life expectancies of themselves and their beneficiaries. The 2001 rules allow an individual to withdraw less, pay fewer taxes and ultimately pass greater wealth on to his or her loved ones. The ability...
to leave more funds in an annuity to benefit from future tax-deferred growth and compounding can have a major impact on the future value of the annuity. For example, if an annuity balance of $100,000 is left untouched while earning a 6 percent rate of return for 60 years, it would grow to $3,298,768.99!

3. Premium payments (Section 10540 of the CIC)

PREMIUM PAYMENTS (CIC 10540)

Premiums for annuities are usually paid in one of these ways:

1) In the first method, the customer pays a single, lump sum premium when the contract is signed. For example, an individual may purchase an annuity with a single payment of $10,000, $50,000, or any other minimum amount that the insurance company will accept. Lump sum premiums can be paid for either immediate annuities or deferred annuities.

2) The second method is available only for deferred annuities. In this option, the customer pays premiums on a regular schedule (annual, semiannual, quarterly or monthly) until the date on which benefit payments begin. Some individuals choose this option because it is similar to making regular deposits in a savings account -- a comfortable, familiar habit. and amount of premium payments. The flexible premium annuity often is attractive to individuals who want a program in which they can vary the amounts they save each year. People who earn commissions or other types of irregular income and families with growing children are two examples of customers who may be interested in a product with this type of flexibility. For example, contract terms of a typical flexible premium annuity may require an initial minimum deposit of $2,500. If the contract remains in effect, the funds that already have been paid in will continue to accrue interest, even if the annuity owner does not wish to pay into the annuity on a regular schedule. Most variable annuities are flexible premium contracts.

PREMIUM PAYMENT PROVISIONS (Section 10540 of the CIC)

All companies have provisions regarding payment of premiums. Annuity contracts accept flexible premiums or a single premium. Since flexible premium contracts are designed to encourage systematic saving, insurers typically set relatively low requirements for additional deposits.

MINIMUM & MAXIMUM PREMIUM PAYMENTS

Companies generally set minimum and maximum limits on the premium amounts they will accept. Minimum limits are set in order to control the administrative costs the company incurs to credit each premium to the contract. Maximum limits are set in order to manage the company's liability for benefit payments under the contract. Minimum and maximum limits vary among companies and types of contracts. Most insurers set maximum allowable deposits based on the insurer's ability to assume the liability of the contract.

- The income will be less than the income using life only annuitization settlement. Because life expectancies of the "uniform table" are longer than standard mortality tables.
- The beneficiary maintains the tax-deferred status on the unpaid death benefit. Under an annuitization option, funds no longer benefit from tax-deferral.

Tax-qualified plans, like IRAs and 403bs, have maximum allowable contributions that prevail when used with annuities.

Minimum premiums are much lower on flexible premium annuities compared to single premium annuities, since the flexible premium product is designed specifically to accommodate the payment of a number of relatively small premiums over a period of time. However, typical minimums vary widely depending on the market in which the company expects to sell the product and the amount of administrative cost the company expects to incur. Sometimes the company will also limit the frequency with which premium payments may be made.

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A separate set of minimums may apply if premiums are being paid via an automatic payment plan (such as automatic monthly transfers from the owner's checking account) or if the annuity is purchased under a qualified plan.

For single premium products, minimum premiums are typically $5,000 or $10,000. Many single premium contracts do not allow any premium payments other than the initial premium. However, some are designed to accept a certain number of additional premium payments within a limited period of time.

**MISSTATEMENT OF AGE OR SEX**

An annuity contract includes a clause that provides for a benefit adjustment if the annuitant's age or sex is misstated in the application. This provision adjusts benefits to those that the premium would have purchased at the correct age or sex. Generally, the payment amount is adjusted and any amounts overpaid are charged against the next payments made to the payee. Any amounts underpaid are added to the next payment. The company sometimes reserves the right to collect from the payee any amounts overpaid.

4. **Surrender charges (Section 10127.10, 10127.12, and 10127.13 of the CIC)**

**SURRENDER CHARGES (Sections 10127.1, 10127.12, and 10127.13 of the CIC)**

Most annuities levy a surrender charge (from 0 to 8%) for any withdrawals that exceed the free withdrawal privilege (typically 10%). The surrender charge usually fades away in time (0 to 10 years). If a client withdraws money from a variable annuity within a certain period after a purchase payment, he will also incur a surrender charge. It is important to advise clients that this charge could affect the value of his account and reduce overall earning potential.

Almost all deferred annuities have **surrender charges**. These charges are assessed during the early years of a contract if the owner liquidates or surrenders the annuity before the insurer has had an opportunity to recover the cost of issuing the contract. In addition to recovering issuing costs, the surrender charges also provide some protection against the risk that increasing interest rates will result in contract owners surrendering their annuity contracts prematurely, forcing the insurer to liquidate its underlying investments at an inappropriate time. Surrender charges help offset the potential loss in the insurer’s portfolio if interest rates escalate after a contract owner purchases the annuity. The penalty is usually expressed as a percentage and assessed against the premium deposited or the account value.

<table>
<thead>
<tr>
<th>YEAR</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
<th>8</th>
</tr>
</thead>
<tbody>
<tr>
<td>SURRENDER CHARGE</td>
<td>7%</td>
<td>7%</td>
<td>6%</td>
<td>5%</td>
<td>4%</td>
<td>3%</td>
<td>2%</td>
<td>0%</td>
</tr>
</tbody>
</table>

Interest rates, bonuses and commissions all have an effect on surrender charges.

- **Higher interest rates** usually mean higher or longer surrender charges.
- **Larger bonuses** usually mean higher or longer surrender charges.
- **Higher commissions** usually mean higher or longer surrender charges.

**Notice of Surrender Charges** A concern with respect to sales to senior citizens is that they may not fully understand, or that an agent failed to fully explain, that their access to contract cash values may be subject to fees called surrender charges. To be sure that senior citizens are aware of these limits on liquidity, any individual annuity contract that contains a surrender charge period must also disclose to the senior citizen:

- the applicable surrender charge period; and
- any and all penalties associated with surrender of the contract.
This 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. **Annual Statement Information** Insurers normally furnish their annuity contract owners with annual statements concerning their contracts. When these annual statements are provided to a senior citizen, they must include the contract’s current:

- accumulation value; and
- cash surrender value.

**SURRENDER CHARGES IN FLEXIBLE PREMIUM ANNUITIES**

Some **flexible premium annuities** incur a new surrender schedule for each additional deposit. Because they no longer have an income from employment, seniors may need to access an annuity sooner than working-aged adults. Therefore, annuities sold to seniors should not subject additional deposits to new surrender charges.

**SURRENDER CHARGE METHODS**

Insurers assess surrender charges in three ways:

- Account value
- Premium deposit
- Loss of interest

**Account Value and Premium Deposit Methods**

The **account value method** uses a fee structure based on a percentage of the full accumulated account value at the time of surrender, whereas the **premium deposit method** is based on a percentage of the premium or premiums that the contract owner deposited into the contract.

- With the **premium deposit** method, the surrender charge percentage is high in the initial years, but reduces over time to zero.
- With the **account value** method, surrender charges that disappear after a certain number of years, but the percentage is fixed at 4 percent. This information can be useful when comparing one contract to another.

Agents should review the provisions of the contracts they sell to determine whether or not they contain surrender charges and what type and fully disclose them to buyers.

**Loss of Interest**

With this type of surrender charge, the contract owner is penalized by a loss of interest over some period of time, usually six months to one year. Loss of interest surrender charges are found on many of the certificate annuities, which creates a close parallel to a bank CD, which typically expresses premature withdrawal penalties as a loss of interest.
<table>
<thead>
<tr>
<th>Premium Deposit Method</th>
<th>Account Value Method</th>
<th>Loss of Interest Method</th>
</tr>
</thead>
<tbody>
<tr>
<td>Surrender charges by year</td>
<td>7%, 6%, 5%, 4%, 3%, 2%, 1%, 0%</td>
<td>4%, 4%, 4%, 4%, 4%, 4%, 4%, 0%</td>
</tr>
<tr>
<td>Basis of surrender charge:</td>
<td>Percentage of premium</td>
<td>Percentage of accumulated value</td>
</tr>
<tr>
<td>Amount of surrender charge:</td>
<td>Year 1</td>
<td>$7,000</td>
</tr>
<tr>
<td></td>
<td>2</td>
<td>$6,000</td>
</tr>
<tr>
<td></td>
<td>3</td>
<td>$5,000</td>
</tr>
<tr>
<td></td>
<td>4</td>
<td>$4,000</td>
</tr>
<tr>
<td></td>
<td>5</td>
<td>$3,000</td>
</tr>
<tr>
<td></td>
<td>6</td>
<td>$2,000</td>
</tr>
<tr>
<td></td>
<td>7</td>
<td>$1,000</td>
</tr>
<tr>
<td></td>
<td>8+</td>
<td>$0</td>
</tr>
</tbody>
</table>

### a. Market value adjustment

**MARKET VALUE ADJUSTMENTS (MVAs)**

In periods of rapidly dropping or rising interest rates, insurers have developed a new tool to adjust yields -- the market rate adjustment (MVA). Simply put, the MVA will increase or decrease the surrender penalty, depending on market rates at surrender compared to the contract period guarantee rate. In other words, the MVA is a separate and additional adjustment made at the time of an early surrender that can be either negative or positive for your client. It all depends if interest rates have increased or decreased at the time your client wants to withdraw his money. The MVA does not typically apply to the free withdrawal portion or surrenders taken after the death of an annuitant.

Market rate adjustments can be very complex. Some are expressed as a factor or percentage rate adjustment tied to a certain block of securities owned by the insurer. If your client decides to withdraw funds from his annuity at a time when market rates have risen, the insured will lose money when selling his securities and need to charge your client a higher penalty. If rates have dropped, there will be less MVA penalty.

Some annuity contracts have a market value adjustment feature. If interest rates are different when the annuity is surrendered than when it was purchased, a market value adjustment may make the cash surrender value higher or lower. Since the contract owner and the insurance company share this risk, an annuity with an MVA feature may credit a higher rate than an annuity without that feature. The MVA can be positive or negative.

- **If interest rates have fallen**, the **MVA will be positive**.
  - It will offset at least a portion of any applicable surrender charges, and perhaps even add to the annuity's surrender value.
- **If interest rates have risen**, the **MVA will be negative**.
  - It will be added to any applicable surrender charges, further decreasing the surrender value.

Some **MVA** products on the market today do not guarantee principal or minimum interest. With these contracts, the market value adjustment can be negative enough to cause a loss of principal, even if a contract owner has owned his or her contract for a number of years. The market conditions that would bring this about would be a rapid and substantial rise in interest rates. Because of this risk, these kinds of MVA products must be registered as securities, and they fall under the category of variable annuities.

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b. Explain the impact of surrender charges on principal

Most contracts impose a fee if the contract is surrendered within the first five to 10 years. This is to cover upfront costs and fees paid by the insurance company paid including the commission to the person who sold the annuity. The higher the fees paid, the longer and higher the surrender penalty will be.

Clients demanding easy access to their money should be prepared to settle for lower overall yields. Agents need to go farther to determine special needs such as the potential for large sums of money to pay for a potential illness or nursing home. Certain contracts allow penalty free withdrawals for special circumstances. Due care dictates that agents carefully and clearly explain all surrender charges associated with the contract and when they occur.

c. Surrender charge waivers - triggering events

SURRENDER CHARGE WAIVERS & TRIGGERING EVENTS

If your client becomes seriously disabled or needs to go to a nursing home, their annuity contract may include a waiver that triggers payments or withdrawals that are not subject to the usual surrender fees. Serious health changes, such as a chronic long term are illness, may also trigger annuity payments.

Not all annuities permit crisis waivers. In general, they seem to be more common and generous in fixed annuities, rather than variable contracts. And, situations that trigger the waiver and allow your client to make early annuity withdrawals vary from company to company. For instance, one insurer might require a 90-day nursing home confinement before your benefits are activated, while another might call for 60 days. In addition, one company may consider that your client is disabled if you're unable to work in any occupation, while another may require that he be unable to work in your current occupation. (A surgeon, for instance, may be deemed disabled by one insurer if he or she cannot operate because of, say, arthritis in the hands. Yet another company might decide that the doctor can still see patients in an office setting, without performing surgery.)

NOTE: California requires individual annuity contracts for seniors to contain a disclosure regarding the surrender charge period unless the contract does not contain those charges. These disclosures should be printed in 12-point bold text.

CRISIS WAIVER PROVISIONS

Crisis waivers allow policyholders to liquidate some or all of the annuity's value due to catastrophic events free of surrender charges.

The Variable Annuity Research and Data Service (VARDS) reports that 161 variable annuity contracts offer some type of waiver. Similarly, Beacon Research, an annuity-tracking service based in Illinois, surveyed 282 fixed annuities and found that 35 percent have a death waiver; 18.5 percent contain nursing home waivers; 7.4 percent have hospital waivers; and a mere 2.3 percent carry disability waivers. While a death waiver is most common in the fixed annuities survey, VARDS shows the most popular waiver found in variable annuities is the nursing home waiver, with 103 variable annuity contracts containing that provision; 83 provide death waivers; 69 have terminal illness waivers; and 42 carry disability waivers. Situations that trigger the waiver and allow early annuity withdrawals vary from company to company. The agent should review such provisions carefully to determine whether any definitional restrictions exist and to understand how broadly or narrowly these provisions apply. It's important to read the policy to find out if it contains any provision under which the surrender or withdrawal would be waived.

Annuity contracts may contain some or all of the following crisis waivers.
i. Nursing homes and similar facilities

Nursing Home Waiver

The nursing home waiver eliminates surrender charges upon withdrawal in the event of a nursing home admission.

- May be annuitant or owner triggered
- May take effect immediately or beginning on the first anniversary
- Usually requires confinement of 30, 60, or 90 consecutive days
- Benefit may be reduced for older purchasers
- Attending physician’s statement may be required along with a completed claim form.

While a 90-day confinement period before benefits kick in may be typical, some insurers impose a 180-day confinement period to a "licensed nursing facility."

Hospital Waiver

A hospital waiver which eliminates surrender charges upon withdrawal in the event of an extended hospital confinement after the annuity was purchased.

- May be annuitant or owner triggered
- May take effect immediately or beginning on the first anniversary
- Usually requires confinement of 30, 60, or 90 consecutive days
- Benefit may be reduced for older purchasers

ii. Terminal illness

Terminal Illness Waiver

The terminal illness waiver eliminates surrender charges upon withdrawal if diagnosed with terminal illness.

- Terminal illness may be diagnosed differently (i.e. less than 6 months to live, less than 12 months to live)
- May be annuitant or owner triggered
- May take effect immediately or beginning on the first anniversary
- Will require certification from a doctor that life expectancy is only a matter of months.
- Benefit may be reduced for older purchasers (e.g. for purchaser older than aged 75, only 50% of account value may be surrendered)

iii. Unemployment

Unemployment Waiver

The unemployment waiver eliminates surrender charges upon withdrawal if unemployment occurs, provided the annuity was purchased prior. Unemployment waivers are very rare.

- Unemployment must be involuntary
- May require proof of gainful employment
- May be annuitant or owner triggered
iv. Disability

**Disability Waiver**

Since the risk of disability is greater than the risk of death at all ages between 20 and 65, it makes sense to protect your clients financially if they become disabled, and that includes annuity considerations. Unfortunately, relatively few insurers offer a disability waiver.

The disability waiver eliminates surrender charges upon withdrawal if physical disability develops.

- May require Social Security Disability benefits as a prerequisite
- May be annuitant or owner triggered
- May take effect immediately or beginning on the first anniversary
- May not be available if over the age of 65 at the time of purchase

Where these waivers exist few will purposefully leave the definition of "disability" fluid. Some may state that if the owner/annuitant is unable to work, and thus can't earn a living, and a doctor attests to this, they will allow full access to the annuity without imposing surrender charges. This is a more liberal interpretation. More than likely, definition of disability will be considerably more stringent.

v. Charges and fees

**Charges and Fees**

In most cases, there's no extra charge for waivers because they're built into the contract when purchased. There are, however, certain tax consequences that could apply to such withdrawals. It is always best to advise your client check with a tax advisor before taking money out of their contract.

In most cases, there's no extra charge for waivers because they're 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. Clients should be advised to check with a tax adviser.

vi. Death

**Death Waiver**

This waiver passes on the full account value of the annuity to a beneficiary if the owner dies before annuitizing.

If death occurs during the surrender period, some contracts waive surrender charges and some do not unless the beneficiary takes the proceeds over a five-year distribution. Agents need to fully explain how a surrender charge would impact the death benefit if heirs elect not to take the distribution over five years.

**Note:** The required notice and printing requirements appear along with each of the required forms or disclosure. The main requirement is that they are conspicuous to the insured/potential insured so that they will not overlook the important notices.

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 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 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."

All individual life insurance policies and individual annuity contracts for senior citizens that contain a surrender charge period shall either 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 Section 10127.10.

5. Policy administration charges and fees

POLICY ADMINISTRATION CHARGES AND FEES

Not all the money a contract owner pays into an annuity is invested, since some is used for sales commissions and fees. These charges differ among companies and among contracts.

Some companies (mostly fixed annuity plans) have no charges other than the surrender fees discussed in the last section. In the event the insured dies, for instance, they guarantee to pay the beneficiary at least the amount paid into the contract, regardless of the current cash value of the contract.

Variable contracts are quite different. Each typically has its own schedule of fees and other charges, and the investor should carefully assess these before making a purchase. These can include annual contract charges, management fees and mortality charges.
ANNUITY FEES AND EXPENSES

Just like other investments annuities have fees and expenses. Costs vary from product line to product line and company to company, and that variable annuities have more features than fixed annuities, so fees and expenses within a variable annuity are generally higher than those found in fixed annuities. A list of the types of fees for annuities is as follows:

- **Investment Management Fees.**
  - Administration Expense and Mortality Risk Charge. This charge ranges from a low of about 0.5 percent to a high of about 1.3 percent.

- **Annual Maintenance Charge.**
  - This charge typically ranges from $0 to $100.

- **Charge Per Fund Exchange.**
  - This charge generally ranges from $0 to $10, but most funds will permit a limited number of charge-free exchanges per year.

- **Maximum Surrender Charge.**
  - Surrender charges vary by company and policy and generally phase-out over a number of years.
  - If the charge is lower, the phase-out range tends to be longer.
  - For example, typical charges and phase-out periods are 5 percent of premium decreasing to 0 percent over 10 years or 8 percent of premium decreasing to 0 percent over 7 years.

PREMIUM TAXES

Several states, including California, impose taxes on the annuity premiums that an insurance company collects. However, in most of those states, annuities funding qualified plans are exempt from those taxes. Premium taxes range from .5% to 3.5%, depending on the state. The significance of premium taxes to contract owners is that they ultimately bear the cost. The method of assessing premium taxes should be covered in an annuity contract and should also be explained in the sales presentation.

WITHDRAWAL PRIVILEGE OPTIONS

Annuities are designed to be long-term investments, however, to compete with other investments, insurers needed to provide some liquidity during the accumulation period of the annuity. Insurers usually allow policyholders to withdraw a portion of the annuity's value free of surrender charges. The amount available differs by contract, but they usually fall into one of three “Free” withdrawal types:

- Interest earnings; or
- A percentage of premium deposited; or
- A percentage of the annuity's value

The “free” amount is typically accessible each year. If a larger amount is withdrawn, it may be subject to withdrawal charges. Clients may lose any interest above the minimum guaranteed rate on the amount withdrawn. Some annuities waive withdrawal charges in certain situations, such as death, confinement in a nursing home or terminal illness.

Most annuities allow withdrawals of up to 10 and percent per year after an initial waiting period of one year, without cost, fee or penalty. The **free withdrawal** is typically based on a percentage of principal, not the current value. However, some companies calculate the penalty free withdrawal on the greater of the current value or principal contributed.
Some companies allow annuity owners to take out all of their account growth (accumulated interest) at any time without a fee or penalty. Others levy penalties only during a prescribed period of time such as the first five or seven years. A few companies also permit cumulative withdrawals.

**TAX PENALTIES FOR WITHDRAWAL**

Even though the withdrawal may be free of surrender charges, tax penalties may still apply. The federal government may impose tax penalties on interest income withdrawn before age 59½. If the annuity is a tax-deferred investment. All interest income is taxable as ordinary income at withdrawal.

**SYSTEMATIC WITHDRAWALS**

Some individuals do not wish to give up the control over their capital that annuitization entails. For these individuals, systematic withdrawal plans provide a way to obtain a regular income from their annuity fund. Although the amounts withdrawn are not subject to favorable tax treatment, interest continues to be credited to the annuity fund on a tax-deferred basis. And although the income stream is not guaranteed to last for the individual’s lifetime, the fund remains within the individual’s control. And the individual still has the option of annuitizing the fund if he or she should wish to do so at some point in the future.

Individuals needn’t make an all-or-nothing decision regarding annuitization. They can guarantee themselves a certain level of income for life and still keep some capital fully under their control by annuitizing only a portion of their annuity fund. They can then withdraw money from the nonconverted portion of the fund from time to time as necessary or obtain regular income from it under a systematic withdrawal. In either case, the possibility remains of converting that portion of the fund, or just another part of it, to a guaranteed lifetime income stream at some point in the future.

**B. Identify and discuss income distributions**

**INCOME DISTRIBUTIONS**

Often an individual does not want to commit to a lifetime payout option. He or she may wish only to take income for a period of time, then reevaluate his or her economic situation and risk tolerance as well as economic conditions in general.

In addition to guaranteed monthly income, one may also make a partial withdrawal from the deferred annuity. However, it is important to keep in mind the IRS may impose a 10% penalty on withdrawals before age 59½ except under certain circumstances.

1. Introduce the application of a split annuity in retirement planning

**UNDERSTANDING THE SPLIT ANNUITY CONCEPT**

*SPLIT FUNDED ANNUITIES* are a comparatively recent development, whereby an immediate annuity and a deferred annuity are combined to accomplish specific financial objectives, including the following:

- Conserving principal
- Maintaining flexibility
- Receiving income
- Providing tax advantages

Split-funding can be useful for people who have a need to generate spendable income over a certain number of years, but also want to preserve their capital.

A Split Annuity is a combination of two annuity products: a **single premium immediate annuity** and a **single premium tax deferred annuity**. Structured in such away as to produce immediate income for a guaranteed period of time and to restore the original principal at the end of that time period.
- **A Deferred Annuity** is used to restore the original principal at the end of the guaranteed period.
- **The Immediate Annuity** provides a guaranteed monthly income for the same time period.

The immediate annuity is used to generate an income stream that is guaranteed not to change for some period certain, typically 5 to 10 years. And, if non-qualified funds are used, only the interest income portion of the immediate annuity will be subject to income taxes, creating tax-advantaged income.

**Advantages of a Split Annuity**

- **Dependable Income**: The Immediate Annuity supplements income by providing a safe, predictable, and guaranteed cash flow. Depending on income needs, the Immediate Annuity can generate a stream of monthly income anywhere from five to twenty years.
- **Tax- Advantaged Income**: Since a significant portion of monthly income from the Immediate Annuity is considered a return of the original investment, it is tax-advantaged.
- **Tax-Deferred Growth and Principal Preservation**: The Deferred Annuity portion of the split-annuity concept offers tax-deferred growth and an interest rate that historically has been higher than average CD rates. In addition, original principal is restored at the end of the guaranteed period.

**Example of a Split Annuity**

<table>
<thead>
<tr>
<th>Immediate Annuity</th>
<th>Deferred Annuity</th>
</tr>
</thead>
<tbody>
<tr>
<td>$38,430 at 6.2%</td>
<td>$61,570 at 6.25%</td>
</tr>
<tr>
<td>Monthly Income</td>
<td>will grow to</td>
</tr>
<tr>
<td>$485.37</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Annual Income</th>
<th>Yr. 1 $65,418</th>
</tr>
</thead>
<tbody>
<tr>
<td>for 8 years</td>
<td>Yr. 2 $69,507</td>
</tr>
<tr>
<td>for which 82% is</td>
<td>Yr. 3 $73,851</td>
</tr>
<tr>
<td>not taxed</td>
<td>Yr. 4 $78,466</td>
</tr>
<tr>
<td>Total Income</td>
<td>Yr. 5 $83,371</td>
</tr>
<tr>
<td>before Taxes</td>
<td>Yr. 6 $88,581</td>
</tr>
<tr>
<td>$46,595.83</td>
<td>Yr. 7 $94,118</td>
</tr>
<tr>
<td></td>
<td>Yr. 8 $100,000</td>
</tr>
</tbody>
</table>

Starting with an investment of $100,000, a "split" annuity can be created that will:

2. **Introduce the various settlement options**

**ANNUITIZATION (SETTLEMENT) OPTIONS**

Whether deferred or immediate, annuities offer a variety of settlement options to help achieve different objectives. An annuity can be used to create an income stream, whether immediate or in the future. The liquidation of a principal sum based on certain contingencies including the duration of the income stream (term, life or a combination of the two) and its investment basis (fixed or variable). Alternatives to annuitization, including surrender and systematic withdrawals, are also available. Each periodic payment consists partly of amortized principal and partly of interest earnings.

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Annuities can play an important role in any situation in which a guaranteed stream of income is needed, especially during retirement. The application of the annuity principle allows individuals to enjoy their retirement years with income they can't outlive. This has brought peace of mind to countless numbers of investors. As longevity continues to increase and individuals begin to live 20 to 30 years (or more) past retirement, a major financial concern is the very real possibility of outliving one's assets. An annuitized income stream guaranteed for as long as an individual lives, addresses this concern.

An annuity stream can be structured for the duration of a person's life, a specified term of years or a combination of both.

Annuitization is the process of converting the lump sum (Principal and Interest) in an annuity into an income stream. There are several annuitization options to select from. The most popular are listed below:

| a. Life |

**LIFE**

- **Life Only** -- Payments continue for life and end upon the death of the annuitant with no refund. The risk with this option is that they could die before receiving the full accumulated value of the investment.

| Guaranteed income for as long as the annuitant lives | Death occurs/Income ends |

The *life-only* option is the purest form of annuitization. It provides a series of guaranteed periodic payments (monthly, quarterly, semiannually or annually) for as long as the annuitant lives. When death occurs, payments stop. Any principal remaining that has not been paid out at the annuitant's death is forfeited. On the other hand, if the individual lives forever, payments continue forever. The younger the annuitant on the date a life settlement is elected, the lower the monthly benefit. Older annuitants who have shorter life expectancy generate higher life settlement benefits.

While life only settlements contain the greatest risk, they also deliver the highest benefit of all life settlement options. This payment option usually pays the highest income possible. Clients might choose it if they have no dependents, if they have taken care of them through other means, or if the dependents have enough income of their own. The risk of life only settlements is that if the annuitant dies before the investment has been returned, the insurance company pockets the remainder.

- **Life Annuity with Period Certain** -- Payments are guaranteed for the life of the annuitant until the date of death. If the period certain has not expired at the time of death, payments will continue to the beneficiary for the remainder of the guaranteed period.

| Guaranteed income for as long as the annuitant lives | Death occurs | Income continues until the end of the guarantee period |
b. Joint survivor

PURE JOINT LIFE

- This payout option provides a specified income amount for two people, but payments stop when the first one dies. No payments continue after the death of either annuitant. This type of payout option is rarely used.

JOINT AND SURVIVOR

- **Joint & Survivor** -- Payments are guaranteed based upon two lives, usually a husband and wife. Full income payments continue until the first death with full or partial payments continuing until the survivor’s death at which time payments cease.

```
| Guaranteed income for as long as both annuitants live. | Death occurs | Income continues at full or partial level | Death occurs/Income ends |
```

This option can be arranged in a number of ways. At the time this option is elected, the benefit may be structured to remain the same upon the death of the first annuitant or it may be reduced. For example, a **joint life and 100 percent survivor** payout provides a certain income benefit to both individuals and, at the death of the first, continues the same payments to the survivor as long as he or she lives. A **joint life and 50 percent survivor** payout provides income payments to two people and, upon the death of the first, makes payments to the survivor equal to half the amount of the initial payments, as long as the survivor lives. By adding the life expectancy of another annuitant, this generates lower income since the insurer is now contractually obligated to make payments over multiple lives. A joint life and survivor option also can include a term certain guarantee. For example, a joint life and survivor payout with a 10-year certain option provides income payments to two individuals and guarantees that if both deaths occur within the first 10 years, payments will continue to a named beneficiary for the remainder of the 10 years. Of course the more guarantees the lower the income payments.

c. Period certain

PERIOD CERTAIN

- **Period Certain** -- Payments continue for a selected period either to the annuitant or their beneficiary.

```
| Guaranteed income for the fixed period you select | Death occurs | Income continues to the beneficiary until end of the original fixed period |
```

**Period Certain Annuity** -- The individual chooses a number of years, such as five or ten, and payments are spread equally over that period. Payments cease at the end of that period even if the individual is still alive at that time. If the individual dies before the end of the term, the remaining payments are made to a beneficiary.

The period certain option is usually available for periods of 5, 10, 15 or 20 years. The longer the guaranteed period, the smaller the amount of each benefit payment.
Period certain settlements provide a reliable way to fund finite needs. They may be used to generate additional income, for specific time frames. Unfortunately, this approach does not produce an income stream that lasts a lifetime.

- **Fixed period** – The owner decides how many years they want to receive income payments and the insurer determines the amount of each income payment.
- **Fixed amount** – The owner decides how much the income payments are to be and the insurer will calculate how long the payments last.

### d. Cash refunds

**REFUND ANNUITIES**

This option is designed to guarantee the return or refund of the annuity's principal if the annuitant dies before the amount he or she paid into the contract is fully liquidated. It can take two forms: *installment refund* or *cash refund*. Under either option, if the annuitant lives to receive payments equal to the principal amount, no future payments are made to a beneficiary.

**INSTALLMENT REFUND**

- **Installment Refund** - Payments continue for life. However, if the annuitant dies before the initial deposit is recovered, payments continue to the beneficiary until the balance has been recovered.

Level payments are received for the annuitant’s lifetime. However, if the annuitant should die before receiving an amount equal to the original premium, the periodic payments will continue to be paid to the designated beneficiary until the total payments made (annuitant and beneficiary) equal the original premium.

**CASH REFUND**

- **Cash Refund** - Payments continue for life. However, if the annuitant dies before the initial deposit is recovered the beneficiary receives the balance as a lump sum.

Level payments are received for the annuitant’s lifetime. However, if the annuitant should die before receiving an amount equal to the original premium, the difference between the premium and the total payments received will be paid in one lump sum to the designated beneficiary.
3. Discuss the advantages and disadvantages of annuitization options

ADVANTAGES AND DISADVANTAGES OF ANNUITIZATION

The primary advantage to annuitization is a structured, guaranteed income flow for the duration of the specified period, whether it's a certain number of years or life. Each month or quarter or year, the insurer promises to make guaranteed payments of principal and interest to the annuitant. Especially for those in retirement, a fixed annuity payout provides a certain, known income that will not change.

The primary disadvantage of annuitization is that it is usually irrevocable. Because the contract owner has converted his or her funds to a distribution mode, he or has probably forfeited any rights to the underlying account balance. The contract owner cannot change the income stream during life. A fixed annuitized payout option commits the annuitant to an income flow and the methodical liquidation of his or her principal. Also, the rates of return on annuity income options are fixed at the point when the contracts annuitize and typically are not very high relative to current interest rates. Fixed annuity payouts in particular offer very little protection against inflation. There is a significant rate of return impact if the annuitant (and his or her survivor) die before life expectancy. These returns are increased if the annuitant and his or her survivor live beyond life expectancy. This compares the relative payout for various annuity options starting with $100,000:

<table>
<thead>
<tr>
<th>Payout option</th>
<th>Amount of Monthly Payment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Life only</td>
<td>$789</td>
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<tr>
<td>Life only with 10-year certain</td>
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</tr>
<tr>
<td>Joint life and 50 percent survivor</td>
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<tr>
<td>Joint life and 100 percent survivor</td>
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<td>Five-year certain</td>
<td>$1,802</td>
</tr>
<tr>
<td>10-year certain</td>
<td>$1,077</td>
</tr>
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</table>

C. Identify and discuss fixed annuities

FIXED ANNUITY CONTRACTS

A fixed-rate annuity is a contract between a policyowner and an insurer that requires a policyowner to pay either a lump sum or periodic payments to the insurer to establish the principal, from which the insurer guarantees the policyowner a fixed or promised rate of return.

The insurer allocates all of the principal invested by the policyowner to a general account, and, in return, makes guaranteed periodic payments to the annuitant out of the insurer's earnings from its investment portfolio held in the general account.

In a fixed-rate annuity: the cash value accumulation (or the annuity income) is a stated dollar amount that is guaranteed by the insurance company and on which (or with respect to the annuity income) the insurer pays a specified or determinable rate of interest. In effect, it is a fixed-dollar, guaranteed-principal kind of investment medium that is in some ways analogous to CDs. The investment authority and investment risk are on the insurance company because it is the insurer that guarantees the cash value (or annuity income) and specifies the interest rate currently being paid on cash value accumulations.

Consequently, unlike variable annuities, fixed-rate annuities have little or no investment risk, because the payout is guaranteed by the insurer/issuer as part of its general account obligations. It is this reason that prompts many insurers and agents alike to compare them to CD’s and even name them similarly as CD Annuities. Be advised, however, while they sometimes offer better rates and helpful tax advantages, they are also much harder to get out of, and they are not protected by the Federal Deposit Insurance Corp.
Some experts advise against CD-type annuities because of the interest costs and IRS penalties involved in getting out. If rates go up, they're locked in at a lower rate.

Some CD-type annuities are different from other fixed annuities in that the guaranteed rate matches the penalty period. In other words, if they buy a five-year CD-type annuity at 4 percent, they're guaranteed to get 4 percent annually if they hold the CD for five years.

Other fixed rate annuities have no maturity date and often guarantee a rate only for the first year. The interest rate usually drops after the guaranteed period and is adjusted annually. Those annuities tend to have a bad reputation, even among people in the insurance industry.

The bottom line with fixed annuities is that tax-deferred earnings or a promise of an income you can't outlive are attractive features to many investors. Other issues to examine, however, include long-term risk, current liquidity, effective earnings (after penalties and bonus interest) and taxes down the road.

Because fixed annuities typically attract people with low risk tolerance, the insurance company's approach to managing fixed annuity investments is conservative. Money deposited into fixed annuities is held in the general account of the insurance company where the insurance company assumes the investment risk. The general account is a diversified investment portfolio consisting of bonds, fixed income securities and real estate. Fixed annuities provide a guaranteed rate of return on the investment and a fixed, stable income in its payout phase. The insurer, not the insured, takes the investment risk. This steady retirement income is, however, subject to inflation.

- Fixed annuities invest in low-risk assets.
- Fixed annuities provide a relatively stable rate of return with low level risk comparable to a CD.
- They are considered a low-risk investment.

**FIXED ANNUITIES**

A fixed annuity is an investment vehicle offered by an insurance company that guarantees to pay a stated rate of interest for a specified period of time. The investor has the choice to accumulate the interest on a tax-deferred basis or take it as income. With a fixed annuity, the insurer, not the insured, accepts the investment risk.

During a fixed annuity's accumulation period, an investor's assets are invested for a specific period of time (the guarantee period). Generally, guarantee periods range from one to ten years; the longer the guarantee period, usually the higher the rate of interest. Renewal rates are announced near the end of the guarantee period. At that time, the investor needs to review their options.

During the payout period, the assets that have accumulated may be returned to the investor based on a fixed annuitization option. Investors may also elect to withdraw their interest. Withdrawals are taxed as ordinary income. IRS regulations may impose a 10% penalty if withdrawals are made prior to age 59½. Withdrawals of principal during the guarantee period may also be subject to surrender charges or market value adjustments.

The primary objective of fixed annuities is to provide investors growth of principal and interest that is free from taxes until withdrawn.

Fixed annuities are an investment alternative for investors seeking growth of principal for purposes such as retirement planning.

**Product Features**

- **Lifetime Income** - Annuities can provide income for various lengths of time, including a lifetime. A lifetime annuitization option is normally only available from an insurance company.

- **Choice of guarantee periods** - The guarantee period an investor selects should be based on their investment time horizon and diversification strategy. Fixed annuities generally offer guarantee periods from one to ten years.
• **Guarantee of Interest and Principal** - The value of a fixed annuity will increase every day that interest is added to the contract. Interest is usually compounded annually and credited daily. The guarantees offered by a fixed annuity are backed by the claims-paying ability of the issuing insurance company.

• **Tax-deferred Growth** - Interest accumulates tax-deferred and is not subject to taxes until withdrawn. Upon withdrawal, the earnings will be taxed at ordinary income tax rates. Note: There are no tax advantages to purchasing a fixed annuity in IRAs, 401(k)s or other similar retirement savings vehicles.

• **Flexible income options** - During the guarantee period, an investor has the option to take systematic withdrawals, usually limited to their interest. Investors have the option to start, stop and adjust their withdrawal amount, subject to certain limitations. An annuity's income stream can also be guaranteed by the insurance company for as long as the investor lives.

• **Probate Avoidance** - Fixed annuity proceeds paid to the beneficiaries upon the investor's death are excluded from probate on their estate; however, the tax-deferred earnings in the contract will be subject to ordinary income tax, and estate taxes would apply to the total value of the contract, if applicable.

• **Penalty for Early Withdrawal** - A 10 percent IRS penalty is assessed on any interest withdrawn from a fixed annuity prior to age 59½.

• **Penalty for Early Surrender** - Investors are assessed a charge for the early surrender of fixed annuities.

• **Benefit to Spouses** - Spousal beneficiaries may usually continue tax deferral if so desired.

### 1. Death benefits

#### DEATH BENEFIT

Principal in a fixed-rate annuity contract is guaranteed everyday. This means that the beneficiary receives the greater of the principal or the value of the account as of the date of the annuitant's death. Beneficiaries may also have options as to how they receive a death benefit, e.g., a lump sum or over a period of years. Accepting a five-year payout, for example, can ease taxes slightly and result in a larger balance due to accumulated interest paid by the insurer. Typical death benefit provisions might last until the contract is terminated, annuitized or the annuitant reaches the age of annuitization . . . anywhere from 75 to 85.

One feature annuities offer that is absent from other investments is a **guaranteed death benefit**. The death benefit payable to the beneficiary of a deferred annuity prior to the annuity starting date is usually equal to the greater of either:

- the total premium paid for the annuity to date, minus any withdrawals, or
- the current accumulated value of the annuity fund.

If death occurs after a contract's maturity date and after annuitized income payments have begun, payments will continue (or cease) as provided for under the distribution option in effect. Generally, no surrender charges or market value adjustments are applied in determining the amount of the death benefit.

### a. Lump sum vs. annuitization

#### OWNER'S DEATH

Federal tax law requires that certain distributions be made from an annuity in the event that any owner of the contract dies. If the owner of the contract is not a natural person, then the annuitant will be considered the owner for the purposes of the rule, and a change of annuitant is treated the same as the death of an owner for tax purposes. Required distributions are as follows:
• If an owner dies after the annuity starting date, any remaining payments that are due under the annuity must continue to be made at least as quickly as payments were being made prior to the death of the owner.
• If the owner dies before the annuity starting date, the entire value of the annuity must either be distributed within five years of the date of the owner's death, or the value of the annuity must be annuitized within one year of the date of the owner's death.

b. Provisions

• Lump-sum payout – distribution of the entire account by the end of the calendar year following the year in which death occurs. Gain taxed accordingly.
• Five-year rule – requires that the beneficiary distribute the entire account by the end of the calendar year that contains the fifth anniversary of death. Gain taxed as distributions occur.

There is one exception to the rule requiring distributions in the event of an owner's death. If the beneficiary of the annuity is the surviving spouse of the deceased owner, then the surviving spouse is permitted to become the owner. Distributions will not be required until the surviving spouse's subsequent death. Other than surrender charges or charges for special features, the fees and charges for fixed annuities are included (or bundled) in the overall price and interest crediting structure of the product.

2. Charges and fees

FEES AND EXPENSES

Most fees and expenses of a fixed annuity are factored into the stated annual percentage rate the investor is quoted. The rate quoted is the rate paid. Fixed annuity fees and expenses generally cover the insurance company's administrative expenses, the cost of offering the annuitization guarantee and profits to the insurance company and agent. Some fixed annuities may assess an annual contract fee, typically around $30.

Although there are fees associated with fixed annuities, clients don’t pay them directly. Fixed annuity fees are reflected in the interest rates credited on the contracts.

3. Interest rate strategies

HOW THE INTEREST RATE IS DETERMINED FOR A FIXED ANNUITY

Amounts credited to cash values are based on the insurer’s current declared rate, subject to a minimum guarantee of about 4 percent to 4.5 percent. Rates may be guaranteed for one to five years. The currently declared rate depends on the performance of the insurer’s general investment portfolio or general account, which is largely invested in fixed income investments such as bonds and mortgages. Similar to a savings account, once interest is credited, the cash value will not decline if the market value of the underlying assets in the insurer’s general account declines. The insurer bears the market risk

Fixed rate contracts may offer a set return for specified period of time. The rate can be guaranteed for this period or simply promised. And rates can also vary widely between companies and products for a variety of reasons. Choosing a suitable rate means uncovering the length of time invested, the promised rate of interest, the guaranteed rate of interest as well as consideration for potential surrender charges if an early withdrawal is required. Many companies offer a first year bonus or teaser rate which can drop considerably in the subsequent years. Many companies are now applying market rate adjustments to any potential surrenders to reflect current market conditions. In other words, while it is important to assess the annual rate of interest credited, it is more likely that a multi-year strategy must be adopted to analyze the effective return of any fixed annuity. The longer the term, the more easily a surrender or MVA charge can be absorbed.
a. Annual

ANNUAL

The traditional deferred annuity offers an initial interest rate which is guaranteed for a period shorter than
the term of the annuity itself. Most traditional annuities guarantee the initial interest rate for one year,
although some products may offer a longer initial rate guarantee, like three years. The insurer re-declares
a new interest rate each anniversary. There is a stated minimum guaranteed interest rate that the renewal
rate may never fall below. During the accumulation period, money (less any applicable charges) earns
interest at rates that change from year to year. Some annuity contracts apply different interest rates to
each premium paid or to premiums paid during different time periods.

b. Multi-year

THE MULTI-YEAR GUARANTEE ANNUITY

Multi-year guarantee annuities are designed with an interest rate that is guaranteed for the full-term of the
annuity. Since a client can accurately predict the value of the annuity throughout the life of the contract,
they are especially useful for reaching a specific value at some time in the future such as retirement.

4. Interest rate crediting methods

METHODS OF CREDITING EARNINGS

When an insurance company invests fixed annuity funds, it uses conservative investments like high
quality bonds and mortgages. When the interest rate period ends, the insurance redeclares a new rate
using one of two methods:

a. Portfolio rates

PORTFOLIO RATES

These contracts offer a guaranteed interest rate for an initial period of time, such as one, three or five
years. After the initial rate period, renewal rates are based on the earnings of the underlying investment
portfolio. In other words, all policyowners are lumped in a single group and given the same rate. When
market rates are declining in the market, the portfolio type of contract would seem to be advantageous.

Portfolio Rate Interest Crediting credits the same interest rate to new and existing policyholders. All
annuity monies go into one large pool or portfolio. The total return of that portfolio is used to establish the
interest rate for all contract owners who buy that annuity. When it comes to renewal time, the insurer
looks at the entire portfolio, regardless of when each individual investor bought his or her contract, and
establishes a renewal rate for the entire block.

b. New money rates

NEW MONEY RATES

New Money Interest Crediting credits interest by investing annuity funds in many different accounts
according to similar interest rate cycles. When the cycle fluctuates, a separate account of investments is
then used to capture the annuity funds received during this new environment. The insurer evaluates each
of the accounts at renewal time to establish the renewal rate by looking at the cash flows from the
underlying investments, reinvestment of the undistributed cash flows and the market value of the
investment portfolio, as well as many other factors. The renewal rate of current policy holders will most
likely be different than the interest rates offered to new policyholders.
c. First year bonus “teaser” rates

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.

BONUS PROVISIONS

Some companies offer a “bonus” rate of interest that will be paid on top of the current, or “base” rate offered on the contract. Interest rate bonuses are generally guaranteed for one interest-crediting period, which is usually one year. The bonus may be in the form of an additional interest rate credited in the first year, or it may be a percent of premium which is credited to the contract immediately, which simply adds an amount to the contract owner's premium deposit at contract issue. Bonuses are popular with variable annuities.

Not all annuity contracts contain bonuses, but those that do are in one of two forms - interest rate bonuses or premium bonuses. Interest rate bonuses vest over the course of a contract year, while premium bonuses vest immediately. If explained and deployed suitably, bonus annuities can be a valuable tool, provided consumers understand that bonuses eventually come to an end. There have been instances where agents misrepresented bonus annuities in presentations and advertisements. The “teaser rates” attached to the first year rate were never explained properly by the agent or in the advertisements. Upon renewal, interest rates were far lower than the first year rate but surrender charges associated with such contracts which made liquidation too costly. As an added safeguard, new provisions of the California Insurance Code (CIC) require any product-specific annuity advertisement targeted at seniors 65 and older to have written approval from the insurer (§787, CIC). Hopefully, this will eliminate deceptive advertising practices regarding bonus annuities.

Agents should be careful when working with clients who already own an annuity and are thinking of exchanging it for a different annuity with a bonus feature should be careful. Even if the surrender period on the current annuity contract has expired, a new surrender period generally will begin when it is exchanged for a new one. This means that, by exchanging the contract, they will forfeit the ability to withdraw money from their account without incurring substantial surrender charges. And the surrender charges and other fees may be higher on the variable annuity with the bonus credit than they were on the annuity that was exchanged. Agents have often used bonus annuities to offset surrender charges from replaced annuity contracts. Agents who intend to replace an annuity owned by a person aged 65 years and older are governed by new regulations, new definitions (and penalties) for “unnecessary replacement”.

"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.”

Some annuity companies offer “bonus” interest to induce an annuitant to initiate a contract or to take a lump sum from an existing annuity and transfer it to them. Using bonus annuities to offset surrender charges with seniors is risky since the bonus alone may not create a substantial financial benefit over the
life of the policy required by law, especially if other provisions are not at least equivalent to the annuity being replaced.

Annuities that offer a bonus credit often have higher charges than annuities with no bonus credit. Assuming that both annuities have the same annual rate of return, prior to expenses, the annuity that will grow the most over the long-haul may well be the one that deducts lower annual charges, even though it does not offer a bonus. Frequently, insurers will offset bonus credits in one or more of the following ways:

- **Higher surrender charges** – Surrender charges may be higher for a variable annuity that pays a bonus credit than for a similar contract with no bonus credit.
- **Longer surrender periods** – Surrender charges may apply for a longer period than they would be under a similar contract with no bonus credit.
- **Higher mortality and expense risk charges and other charges** – Higher annual mortality and expense risk charges may be deducted for a variable annuity that pays a bonus credit. Although the difference may seem small, over time it can add up.

Before recommending a variable annuity with a bonus credit agents should determine whether the bonus is worth more than any increased charges for the bonus. This may depend on a variety of factors, including the amount of the bonus credit and the increased charges, how long annuity contract the annuity is held, and the return on the underlying investments. Agents also need to consider the other features of the annuity to determine whether it is a good investment for their clients.

Under some annuity contracts the insurer will revoke all bonus payments made within a specified period if clients make a withdrawal, if a death benefit is paid to beneficiaries upon death, or under certain other circumstances.

**d. Explain annualized interest rate calculations on bonuses that apply to fixed accounts**

**BONUS CREDIT RIDER**

Usually, this rider is offered on many deferred annuities as an incentive to buy. There is often a relationship with the surrender charge schedule and the amount of bonus interest offered. The more bonus interest offered, the higher or longer the surrender charge will be. In a variable annuity the bonus may be accompanied with either a higher surrender charge or an additional percentage charged against the account values. In an attempt to attract investors, many variable annuities now offer bonus credits that can add a specified percentage to the amount invested in the variable annuity, generally ranging from 1% to 5% for each premium payment made. Bonus credits, however, are usually not free. In order to fund them, insurance companies typically impose high mortality and expense charges and lengthy surrender charge periods. Bonuses are not inherently bad, but the buyer must understand the necessary trade-off he or she accepts when purchasing a bonus annuity. The agent must advise the client to consider whether the bonus is worth more than its cost.

The answer rests on a number of factors:

- Amount of the bonus credit
- Amount of the increased charges
- How long the client plans to hold the annuity contract

Depending on how long the client holds the contract, the bonus annuity with increased annual charges may produce a lower overall account value than a lower priced annuity with no bonus. The controversy over bonuses is not that they're being offered, but how they're being marketed. Some companies use this feature to pursue Section 1035 exchanges aggressively. The bonus may be used as an inducement to buy or as an offset to any surrender charge that the contract owner faces when surrendering the existing contract.
5. Minimum Guaranteed Interest Rates (Section 10168.25 of the CIC)

**Minimum Guaranteed Interest Rate (Section 10168.25 of the CIC)**

Beginning January 1, 2006, the state of California, new legislation (CIC 10168.25) regarding minimum guaranteed interest for fixed annuities. The primary goal of the law's revision is to provide a means to permit lower interest rate guarantees than the current law allows in low interest rate environments. Legislators agreed on a cap equal to the existing three percent interest rate.

However, in order to provide some minimum level of guarantee to the consumer, a floor of one percent was also established. Finally, flexibility was provided to the companies by allowing for the redetermination of the minimum interest guarantees on a periodic basis by using the five-year Constant Maturity Treasury Rate, less 125 basis points AB 284 also significantly reduces the maximum expense loads that may be charged by an insurer by limiting annual contract fees to $50. This bill, however, is does not affect any contract now in effect.

The passing of this bill is a strong indication that the current low interest rate markets are having an impact. Annuities are one of the few savings products that offer guaranteed lifetime income, ensuring that a person will not outlive their assets. Extremely low rates have had negative effects on the ability to accomplish.

Fixed annuities have a guaranteed minimum interest rate and a current rate that is higher than the guaranteed minimum. The minimum rate is guaranteed for the life of the annuity. The current rate is guaranteed for a shorter period, usually one year. Annuity owners can expect the current rate to change periodically while the guaranteed minimum rate represents the lowest rate the annuity will earn.

Minimum annuity interest rates reflect, in part, the reserving and nonforfeiture requirements that insurers must meet. In effect, the minimum interest rate provides a guaranteed worst-case scenario relative to a fixed contract's growth. For most fixed annuities, the minimum rate is 3 to 4 percent.

**Current Interest Rate**

The current rate is the rate the company credits to the contract at a particular time. The company will guarantee it not to change for some time period. Current rates offered on annuities vary much more widely and frequently than guaranteed minimum rates.
a. Low interest rate market & its impact on interest rates

<table>
<thead>
<tr>
<th>Low Interest Rate Environment Impact on Interest Rates</th>
</tr>
</thead>
<tbody>
<tr>
<td>In a Rising Rate Environment…</td>
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<td>Initial Period</td>
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<tr>
<td>Initial annuity rate</td>
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</tr>
<tr>
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<td>5.0%</td>
</tr>
<tr>
<td>Sales</td>
</tr>
<tr>
<td>$100 million</td>
</tr>
<tr>
<td>1 year later</td>
</tr>
<tr>
<td>Market rate</td>
</tr>
<tr>
<td>9.0%</td>
</tr>
<tr>
<td>Annuity rate*</td>
</tr>
<tr>
<td>6.0%</td>
</tr>
<tr>
<td>Competitor’s rate</td>
</tr>
<tr>
<td>7.0%</td>
</tr>
<tr>
<td>Company sales</td>
</tr>
<tr>
<td>$100 million</td>
</tr>
</tbody>
</table>

*This is the renewal rate for existing business as well as the initial rate for new business. It is determined by weighting half of the portfolio at 7 percent and half at 5 percent (5 percent derived from market rate minus spread).

D. Identify and discuss variable annuities

VARIABLE ANNUITIES

To understand the structure of the variable annuity, we must compare it to the fixed annuity. Like the fixed annuity, the variable annuity is a contract between an individual and a life insurance company. With both types, the owner contributes premiums that, along with their earnings, are accumulated within the policy contract. At an agreed-upon time, the insurance company begins making payments to the annuitant. Payments are made over the individual’s lifetime or for some other stipulated period.

In general, insurance companies invest funds for their fixed products in long-term bonds and other non-speculative issues. In contrast, the premium payments made on a variable annuity are not combined with the insurance company’s general investments; instead, they are placed in stocks, government securities and other types of fluctuating investments. These investments have more growth potential than those that underlie other investments, but they are also subject to a greater degree of risk. The investments make up a portfolio that is managed in much the same way as a typical mutual fund. For many years, marketers of annuity products, along with savings institutions, emphasized the advantages of conservative and secure investments.

Then, rising inflation rates began to affect the average person’s standard of living. Beginning in the 1960s, people became aware that they had to plan for more retirement dollars just to keep pace with anticipated increases in living costs. Savers sought financial instruments that could more readily keep up with inflation. Individuals of even average means were turning to the stock market for an increasing portion of their investments. Like savings institutions, insurance companies looked for ways to improve their traditional products. In an attempt to combine traditional annuity guarantees with the growth potential of a securities investment, they developed the variable annuity. The prospectus will warn potential investors against all of these issues.

A variable annuity is a type of investment offered by an insurance company which is designed to help an investor save for and create a stream of payments during retirement. The investor gives the insurance company a sum of money that is invested according to the investor’s objectives. Money is then allocated among professionally managed variable subaccounts selected by the client.

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During a accumulation period, an investor's assets increase or decrease based on the investment performance of the selected subaccounts; investors are not guaranteed a specific rate of return. The subaccount investments of a variable annuity are subject to market fluctuation.

During the payout period, assets that have accumulated may be returned to the investor based on the annuitization option (either fixed or variable) and the annuity payout option the investor selects. Investors may also take discretionary withdrawals that may be subject to tax penalties or surrender charges.

The Objective is to provide investors the opportunity for market appreciation with tax-deferred accumulation and future (retirement) income.

- Growth or loss based on performance of investment sub-accounts
- Principal as well as previous earnings are subject to risk

The annuity owner may choose to invest in a broad spectrum of separate accounts, which are similar to mutual funds. In contrast with fixed rate annuities, cash values depend on the market value of the underlying assets in the selected separate accounts. Variable annuity owners bear the market risk of investment without minimum interest rate guarantees. However, they have the flexibility to choose their investment portfolio and the potential to earn far greater total returns than on fixed rate annuities.

Variable annuities generate returns that fluctuate in value over time, based on the performance of the underlying portfolios they are invested in. Since the stock market has generally outpaced inflation, variable annuities are useful in protecting against the effects of inflation.

A variable annuity is designed to take advantage of the investment opportunities found in the stock market. Like other deferred annuities, variable annuities enable clients to accumulate money tax-deferred in order to provide an income at a later date. Variable annuities offer the choice of several investment divisions such as stocks, bonds, and money market funds, which can cause the rate of return to fluctuate with market conditions. The amount of money that the insurance company will pay upon annuitization depends on which investments selected and how they performed during the accumulation period. With a variable annuity, the owner, not the insurance company, assumes the investment risk. There is no guarantee of principal. There is no guaranteed minimum return. The value of the annuity depends on the performance of its underlying investments. Because the owner bears the investment risk, variable annuities are regulated as securities. In addition to a state insurance license, sales representatives must have the appropriate state and federal securities licenses to sell variable annuities and must comply with state and federal securities regulations in their variable annuity sales and service activities.

Variable annuities are sometimes used by investors who like to trade (buy and sell) mutual funds often and who do not need their money for many years to come, especially those in a very high tax bracket now who expect to be in a much lower tax bracket at retirement.

PRODUCT FEATURES

- **Lifetime Income** - Annuities can provide income for various lengths of time, including a lifetime. A lifetime annuitization option is normally only available from an insurance company.
- **Diversification** - Variable annuities enable individuals to invest in professionally managed subaccounts. A subaccount is similar to a mutual fund and is separate from the general assets of the insurance company. Subaccounts offer a diversified range of investment objectives, and each subaccount invests in a diversified portfolio of securities.
- **Professional Management** - A subaccount is managed by an individual or team of individuals who select the investments based on the subaccount's investment objectives.
- **Guaranteed Death Benefit** - If the policyholder dies, the beneficiary is usually guaranteed the amount originally invested, minus previous withdrawals. Some variable annuities offer death benefit options, which may increase death benefit over time.
- **Tax-deferred Growth** - Increases in the value of the annuity are not subject to taxes until withdrawn. Upon withdrawal, the earnings will be taxed at ordinary income tax rates. Note: There
are no additional tax advantages to purchasing a variable annuity in IRAs, 401(k)s or other similar retirement savings vehicles.

- **Liquidity** - Most variable annuities allow policyholders to withdraw a portion of their investment. Withdrawal policies are defined in the annuity policy; withdrawals may be subject to a contingent deferred sales charge, loss or reduction of certain insurance benefits, and income taxes.
- **Living Benefit** - Some variable annuities enable the policyholder to elect an optional living benefit. These benefits can provide certain guarantees for contract withdrawals or annuitization payments during your lifetime.
- **Probate Avoidance** - When the death benefit in a variable annuity is paid to the named beneficiary, the proceeds are generally not included in the probated estate. However, the proceeds are subject to ordinary taxes of the beneficiaries and estate taxes. Investors seeking a death benefit not subject to taxation should consider life insurance.
- **Penalties for Early Withdrawal** - Withdrawals taken from an annuity prior to age 59½ may be subject to a 10 percent federal penalty.
- **Market Value Fluctuation** - The value of variable annuities is subject to market fluctuation.
- **Benefit to Spouses** - Spousal beneficiaries may usually continue an annuity contract and maintain the tax deferred status, if so desired.

**COMPUTATION OF ANNUITY ACCUMULATION AND PAYMENTS**

Owners of variable annuities receive regular statements on the value of their investment accounts. Like CD owners and other investment holders, annuity owners want to know the current values of their holdings. Computing the value at any given time of a variable annuity contract can be complex. With available annuity, one is dealing with fluctuating stock market investments. The process, therefore, is more complicated than calculating the value of a CD, which has a guaranteed interest rate over a specified time period.

Most insurance companies have adopted a unit method of expressing annuity values. Generally, two types of units form the variable annuity contract. These units correspond to the two basic time classifications for annuities: the period during which dollars are being accumulated (accumulation period) and the period in which the insurance company makes the annuity payments (distribution period).

**ACCUMULATION UNITS**

During the years in which premiums are paid into the contract, the annuity owner acquires accumulation units. Accumulation units have a designated initial price at the time of the annuity purchase, but fluctuate in value thereafter. In the case of company-managed products, the changing values will correspond to the performance of the pool of investments. This is similar to the way mutual fund values are expressed. With a mutual fund share, each accumulation unit of a variable annuity has a designated value on a given day. In the case of self-directed annuities, the values of the fund or combination of funds the policy owner has chosen are totaled. The value of each accumulation unit is then calculated from this total.

Under both company-managed and self-directed plans, each premium payment purchases a certain number of accumulation units. The number of units varies according to the unit’s current market value. The number of units continues to increase as additional purchases are made, although each unit’s value will vary over the life of the contract, according to its worth in the marketplace. This, too, is similar to the manner in which mutual fund share values are calculated.

Premium dollars, deposited into a VA contract, are used to buy accumulation units based on the net asset value of the separate account funds at the time of purchase. A contract's accumulation unit has a given value when the contract is issued, and the initial premium deposit buys accumulation units at that price. For example, a $5,000 premium deposit in a VA in which the units are valued at $5 would purchase 1,000 accumulation units. The units represent the purchaser's ownership of the particular subaccount or subaccounts in which his or her premiums are invested. From that point on, the value of an accumulation unit fluctuates in response to the underlying funds in which the contract's values are invested; the insurer regularly (usually daily) revalues the units accordingly. Each revaluation reflects the gains or losses the
investment account experienced. After deductions are taken for expenses and fees, future premium deposits are applied to purchase additional accumulation units at their current value. The annuity accumulation unit value (AUV) is usually calculated daily.

The following example illustrates how this works out in practice:

| Initial Value of Accumulation Unit on 1/1/04 | $5 |
| Monthly Premium Payment | $100 |
| Initial Number of Units Purchased | 20 |

<table>
<thead>
<tr>
<th>Subsequent Values of Accumulation Unit</th>
<th>Number of Units Purchased</th>
</tr>
</thead>
<tbody>
<tr>
<td>2/1/04</td>
<td>$5.05</td>
</tr>
<tr>
<td>3/1/04</td>
<td>$4.87</td>
</tr>
<tr>
<td>4/1/04</td>
<td>$4.94</td>
</tr>
<tr>
<td>5/1/04</td>
<td>$4.99</td>
</tr>
<tr>
<td>6/1/04</td>
<td>$5.12</td>
</tr>
</tbody>
</table>

At the end of the six-month period, the owner will have a total of 120.14 accumulation units. As stated above, the value of these units will continue to fluctuate according to the unit’s market value. With each premium payment, the contract owner adds to the total of accumulation units.

The accumulation unit price will probably continue to fluctuate. When the annuity matures, the contract owner will have been credited with a specified number of accumulation units.

**ANNUITY UNITS**

In order for the insurance company to begin paying out income from the annuity, accumulation units are converted into annuity units.

An annuity unit is a measure of value that an insurance company uses when it calculates the amount of income to be paid to an annuitant. At retirement, the annuitant is credited with a designated number of annuity units.

The exact number of annuity units to be credited depends on four basic factors.

- The first factor is the **annuitant's age**. As described earlier, the insurance company calculates from its mortality tables all charges in order to provide a designated amount of lifetime income at a specified age.
- The second factor is the number of **guaranteed payments**. If the annuitant chooses a period certain life income option, the extra charge for that benefit will be reflected in the calculation of the annuity unit.
- The third factor is the **interest rate** that the insurance company projects. If the company predicts a fairly high interest rate, the annuity unit will have a greater value than it would with a lower rate. Interest rates typically are projected annually to determine the projected investment return.
- Finally, there are **administrative expenses** to be incorporated into the unit cost calculation.

**Fluctuating Value of Annuity Units**

The calculated number of annuity units remains constant over the payment period. The annuitant has the option of choosing a fixed or a variable payment, or, as is often the case, a combination of both.

With the variable payout, the annuity unit’s value may fluctuate, just as it does during the accumulation period. The value will continue to vary according to the performance of the underlying investment portfolio and the general administrative costs that the company incurs.
Obviously, the amount of periodic income also will fluctuate.

For example, suppose that on January 1, the date the annuitant retires, he or she has collected a total of 10,000 accumulation units. Assume further that at that time the 10,000 units have a market value of $50,000.

Using the above process, the insurance company then converts the annuitant’s 10,000 accumulation units to 100 annuity units.

On the first payment, each annuity unit is worth $10. If the annuitant chooses the fixed payment option, the $1,000 monthly payment, as listed in the example below as of January 1, would remain constant for the balance of the payout period.

Assume that the annuitant chose a variable mode of payment. In that case, a six-month projection of monthly payments would be as follows:

<table>
<thead>
<tr>
<th>Date</th>
<th>Annuity Monthly Payment</th>
<th>Unit Value to Annuitant</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/1</td>
<td>$10.00</td>
<td>$1,000</td>
</tr>
<tr>
<td>2/1</td>
<td>10.17</td>
<td>1,017</td>
</tr>
<tr>
<td>3/1</td>
<td>9.73</td>
<td>973</td>
</tr>
<tr>
<td>4/1</td>
<td>9.89</td>
<td>989</td>
</tr>
<tr>
<td>5/1</td>
<td>10.11</td>
<td>1,011</td>
</tr>
<tr>
<td>6/1</td>
<td>10.57</td>
<td>1,057</td>
</tr>
</tbody>
</table>

There are two important reasons for the continued fluctuation in variable annuities after the retirement income period begins.

The first is that the portfolio’s value constantly changes to reflect current market conditions. The second is that the investments funding the annuity contract also change continually, just as they do during the accumulation period. The various stocks, bonds and other financial instruments that make up the portfolio continue to be bought and sold. In a company-managed plan, the insurance company’s investment managers continue to supervise this process. In a self-directed plan, the contract owner may frequently change the contents of the portfolio.

VARIABLE ANNUITY INCOME AND LIQUIDITY OPTIONS

Free Withdrawals

Most variable annuities provide for withdrawal of a specified amount free of charge. Withdrawals in excess of the amount specified are possible but, in the early years of the contract, may trigger surrender charges. They may also encounter a "market value adjustment" (MVA). While a variable annuity’s free withdrawal provision allows access to a portion of the contract’s values without a surrender charge, any withdrawals still are subject to income tax and possibly a penalty if taken before age 59½.

VARIABLE ANNUITIZATION

Variable annuities can also be annuitized. Variable annuitization not only provides a guaranteed life income but can also provide the ability to respond to inflation. Like the cash values of variable annuities themselves, the income stream from variable settlement options also fluctuates.

Variable annuity contract owners have the option of annuitization; converting the funds in their annuities to income streams, guaranteed for a certain period of time, for life or for a combination of the two. Most companies offer several annuity options, based primarily on how long the income will last. First, the insurance company converts accumulation units to "annuity units", which result in payouts that are partly a tax-free return of principal and partly taxable earnings.

Meanwhile, the undistributed portion of the investment continues to compound, tax-deferred.
Variable annuitization involves a contract owner selecting an assumed interest or investment rate, known as the AIR. Based on that rate and the payment period, the carrier determines the initial (typically monthly) payment, then converts the payment into units based on the annuity unit value at the time of the initial payment. Subsequent distributions are of the same number of annuity units, but the value of the units varies, based on the performance of the underlying separate account.

Often the contract will offer a limited selection of AIRs, such as 3%, 5%, or 7%. Choosing the higher rate assumption will provide the highest initial income. But it will decrease the fastest if the net returns of the subaccounts fail to keep pace with the selected return. Determining which assumed interest rate to use depends on the risk tolerance of the client. A more conservative client will usually choose a more conservative AIR, hoping that the monthly income will go up over time. A more aggressive client will choose a higher AIR expecting that the income stream will stay high. Because the variable annuity houses fixed and separate accounts within the same product, the annuity owner has an option to create a mixture of fixed payments and variable payments. The contract owner allocates a dollar amount to the fixed account that will result in a guaranteed fixed payment stream for the term selected by the contract owner with the balance annuitized in the separate account.

Variable annuities are designed to be long-term investments, to meet retirement and other long-range goals. Variable annuities are not suitable for meeting short-term goals because substantial taxes and insurance company charges may apply if the money is withdrawn early. Variable annuities also involve investment risks, similar to mutual funds.

**Bonus Credits**

In an attempt to attract investors, many variable annuities now offer bonus credits that can add a specified percentage to the amount invested in the variable annuity, generally ranging from 1% to 5% for each premium payment made. Bonus credits, however, are usually not free. In order to fund them, insurance companies typically impose high mortality and expense charges and lengthy surrender charge periods. The more bonus interest offered, the higher or longer the surrender charge will be. Bonuses are not inherently bad, but the buyer must understand the necessary trade-off he or she accepts when purchasing a bonus annuity. The agent must advise the client to consider whether the bonus is worth more than its cost. The answer rests on a number of factors:

- Amount of the bonus credit
- Amount of the increased charges
- How long the client plans to hold the annuity contract

In a variable annuity the bonus may be accompanied with either a higher surrender charge or an additional percentage charged against the account values. Depending on how long the client holds the contract, the bonus annuity with increased annual charges may produce a lower overall account value than a lower priced annuity with no bonus.

The controversy over bonuses is how they're being marketed. Some companies use this feature to pursue Section 1035 exchanges aggressively. The bonus is often used as an inducement to buy by offsetting any surrender charge that the contract owner faces when surrendering the existing contract. The SEC is investigating this practice.

The SEC has issued the following consumer warning: "If you already own a variable annuity and are thinking of exchanging it for a different annuity with a bonus feature, you should be careful. Even if the surrender period on your current annuity contract has expired, a new surrender period generally will begin when you exchange that contract for a new one. This means that, by exchanging your contract, you will forfeit the ability to withdraw money from your account without incurring substantial surrender charges... (and) the charges and other fees may be higher on the annuity with the bonus credit than they were on the annuity that you exchanged." Agents who market bonus annuities must avoid unnecessary replacement activity and must diligently disclose the ultimate cost of the bonus to their clients so they can make an informed decision.

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1. License requirements

VARIABLE LICENSE IN ADDITION TO INSURANCE LICENSE.

Agents must submit acceptable proof of registration with the Financial Industry Regulatory Authority (FINRA). Acceptable proof must show that they have completed Series 6 and Series 63 per Section 260.217 of the California Code of Regulations.

a. Prospectus

PROSPECTUS

Variable annuities are considered securities and must be registered with the SEC. The SEC requires that all variable annuity sales materials include a prospectus, which contains all of the relevant information regarding the contract. The prospectus is a valuable tool which reveals any hidden charges not defined clearly in the supporting marketing materials. The prospectus outlines all costs and benefits, defines terms, discusses the issuer and gives the potential contract owner information. When used properly the prospectus can be an effective sales tool. Since variable annuities are securities, a prospectus must be delivered to a prospect before, or at the time of, sale. The prospectus provides the client with essential information regarding the variable annuity. Information contained in a prospectus includes:

- Charges and fees
- Listing of subaccounts
- Description of what investments can be made in each subaccount
- Description of the subaccount objective
- Additional benefits
- How to determine the death benefit

b. Financial Industry Regulatory Authority (FINRA)

THE FINANCIAL INDUSTRY REGULATORY AUTHORITY

The Financial Industry Regulatory Authority (FINRA) is the largest independent regulator for all securities firms doing business in the United States. All told, FINRA oversees nearly 4,700 brokerage firms, about 167,000 branch offices and approximately 635,000 registered securities representatives. Created in July 2007 through the consolidation of NASD and the member regulation, enforcement and arbitration functions of the New York Stock Exchange, FINRA is dedicated to investor protection and market integrity through effective and efficient regulation and complementary compliance and technology-based services. FINRA touches virtually every aspect of the securities business—from registering and educating industry participants to examining securities firms; writing rules; enforcing those rules and the federal securities laws; informing and educating the investing public; providing trade reporting and other industry utilities; and administering the largest dispute resolution forum for investors and registered firms. It also performs market regulation under contract for The NASDAQ Stock Market, the American Stock Exchange, the International Securities Exchange and the Chicago Climate Exchange.

FINRA has approximately 2,800 employees and operates from Washington, DC, and New York, NY, with 15 District Offices around the country. FINRA believes investor protection begins with education. Using the Internet, the media and public forums, we help investors build their financial knowledge and provide them with essential tools to better understand the markets and basic principles of saving and investing. In addition, the FINRA Investor Education Foundation is the largest foundation in the U.S. dedicated to investor education. As of April 2009, the Foundation had approved approximately $46 million in investor education and protection initiatives through a combination of grants and targeted projects.

In today's fast-paced and complex global economy, FINRA is a trusted advocate for investors, dedicated to keeping the markets fair, ensuring investor choice and proactively addressing emerging regulatory issues before they harm investors or the markets.

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2. Typically common contract provisions

COMMON CONTRACT PROVISIONS

Variable annuities come in many different flavors. One difference lies in who has control over investing the money deposited into the annuity. With *general accounts*, the insurance company determines how the annuity funds are invested. Others use *separate accounts* which allow the annuity owner to have substantial control over the investment of funds.

Choices among annuity contracts are numerous and can be quite complex. It is your ethical and legal responsibility to know the difference between various contracts you are selling as well as options that are widely available. Following is a discussion of provisions common to many annuity offerings:

The following contract provisions are common to Variable Annuities:

| a. General vs. Separate accounts |

**SEPARATE ACCOUNTS vs. GENERAL ACCOUNT**

Deposits made into variable annuities are invested into a separate account, divided into subaccounts. Subaccounts consist primarily of investments in stocks, bonds, mutual funds, and T-bills. Agents must understand that the investment risk is assumed by the investor.

**SEPARATE ACCOUNTS**

- Annuitant bears investment risk
- Consists of stocks, bond, mutual funds, etc.
- Sub-account assets are protected from potential claims of the insurance company's creditors

Many companies offering variable annuities also offer fixed account options to compliment the subaccounts. Money in the fixed account is held in the *general account* of the insurance company. The general account is a diversified investment portfolio that is used for investments in the fixed interest account. Unlike the subaccounts, the investment risk associated with money in the general account is assumed by the insurance company.

**GENERAL ACCOUNT**

- Insurer bears investment risk
- Consists of fixed income securities and real estate
- General account assets are not protected from potential claims of insurance company's creditors

| b. Variable options |

**VARIABLE OPTIONS**

Most variable annuities provide a range of options, from various types of stock and bond funds to money market funds and even a fixed account option. Premiums allocated to the fixed account option are guaranteed against investment risk and are credited with a guaranteed minimum return.

**Company-Managed Variable Annuity**

The insurance companies’ investment managers buy and sell these investments on a continuing basis. Like mutual fund managers, the insurance company tries to invest the money wisely and profitably so that it will generate a competitive return for its investors. In addition, the insurance company must meet both state and federal regulations regarding investment practices for these products. (Variable annuities are
subject to regulation by the Securities and Exchange Commission, Internal Revenue Service and state regulatory bodies.)

One of the better-known company-managed variable annuities is the College Retirement and Equities Fund, or CREF. Designed by the Teachers Annuity and Insurance Association, it was the first variable annuity, appearing on the market in 1952. Because of CREF’s relatively long history, it has been the subject of many detailed studies.

**Self-Directed Variable Annuity**

With the self-directed variable annuity, the contract owner can choose from several investments... *subaccounts*... each with different goals. This allows an investor to diversify his holdings and select investments based on his or her objectives in much the same manner that a mutual fund investor does. Following are some typical choices:

- **Equity-Based**: Funds are invested in steadily growing, strong companies with a history of growth potential. The goal is long-term growth.
- **Risk-Based**: Exposure to companies on the cutting edge of innovation. The goal is to capture significant investment opportunities with the potential for greater price volatility (more risk).
- **Fixed Options**: The fixed portion of a variable annuity emulates the fixed annuity. So, anytime an investor has had enough of choices or decides its time to move from equity- or risked-based position, he can move his funds here.

In effect, the contract owner may construct a personal investment portfolio within the annuity and his selection of investments can generally be made during both the accumulation and distribution periods.

**TYPES OF VARIABLE ANNUITY SUBACCOUNTS**

Today, variable annuity buyers have many investment options for the allocation of their contract funds, with more being introduced each day. This has made it possible to choose investment options that match a buyer’s goals, objectives and risk tolerance. The majority of variable annuities let clients choose among portfolios of stocks, bonds and money market instruments. They allocate money to purchase accumulation units in different portfolios, depending upon how aggressive or conservative they wish to be. Clients choose the portfolios in which they will invest from among those offered. The insurance company backing the annuity develops a relationship with a professional money manager, whose experts decide which specific stocks and bonds will be a part of each portfolio. In some newer variable annuities, clients can take advantage of more than one expert money manager, allowing even more flexibility in structuring their investment.

Owners are permitted to make transfers, or exchanges, of their funds among the available investment options, subject to some restrictions, such as frequency of transfers, number of transfers per year, minimum dollar amount or percentage of sub-account value transferred, or minimum dollar amount or percentage of value remaining in the sub-account.

**Choosing an Annuity Investment Portfolio**

The annuity application form lists the selection of investments that the insurance company offers. Based on his investment objectives, the customer indicates, usually in percentage units, how each premium is to be allocated among the selected accounts. Most contracts allow an unlimited number of percentage combinations. The applicant can even allocate the entire premium to a single investment choice.

A typical offering might include four mutual funds with differing objectives, plus a fixed account. The fixed account offers guaranteed safety of principal and specifies a fixed interest rate. (Interest rates on the fixed account may be guaranteed for periods ranging from one calendar quarter to one or two years or even longer.)
ASSET ALLOCATION

Asset allocation is a process through which an investor allocates money across different asset classes, like stocks, bonds, cash and real estate. The process reflects an investor's personal attitudes about investing by addressing a variety of factors. When the contract owner elects this option, the company's asset managers move the money for the contract owner and change the allocation percentage for future deposits. The contract owner can designate part or all of his or her account to be moved and spread as the money manager sees fit.

Keys to Asset Allocation:

- Define Goals
- Gauge Risk Tolerance
- Look at the Big Picture
- Match Products to the Profile
- Choose a Mix that Suits Clients Needs

Through diversification, clients can help "spread" their risk by holding products that invest in different asset classes—equities, fixed-income, real estate, money market funds, and guaranteed accounts. Diversification helps offset the volatility of a single investment and take advantage of the earning potential of several. The key is asset allocation—choosing and maintaining the right combination of investments to reach clients goals, based on their risk tolerance and time horizon.

<table>
<thead>
<tr>
<th>INVESTOR PROFILE</th>
<th>INVESTMENT OBJECTIVE</th>
<th>ASSET CLASS COMPOSITION</th>
</tr>
</thead>
<tbody>
<tr>
<td>Conservative</td>
<td>Preservation of Capital</td>
<td>Fixed Income: 80% Equity: 20%</td>
</tr>
<tr>
<td>Moderate-Conservative</td>
<td>Moderate Growth</td>
<td>Fixed Income: 59% Equity: 41%</td>
</tr>
<tr>
<td>Moderate</td>
<td>Steady Growth In Asset Values</td>
<td>Fixed Income: 41% Equity: 59%</td>
</tr>
<tr>
<td>Moderate-Aggressive</td>
<td>Moderately High Growth In Asset Value</td>
<td>Fixed Income: 24% Equity: 76%</td>
</tr>
<tr>
<td>Aggressive</td>
<td>High Growth In Asset Value</td>
<td>Fixed Income: 6% Equity: 94%</td>
</tr>
</tbody>
</table>

SUBACCOUNT REALLOCATION

An investor's financial objectives often change over time as well. Working-aged adults are usually focused on aggressive growth during their peak earnings years. As they approach retirement, however, they become more conservative. Investors in variable annuities have the flexibility to reallocate funds in subaccounts. Most variable annuity contracts allow for twelve or more transfers per year without charge.

d. Equity-based

EQUITY-BASED

Growth Stock Subaccount

The investment of a growth stock subaccount is focused primarily on investments in common stock of companies that have above average growth potential. Growth stock subaccounts could be further specialized by targeting large cap, midcap, and small cap companies. Depending on the objectives, some growth funds are aimed at more aggressive growth while others seek more conservative capital gains,
with some dividend distribution to provide limited income. Some funds even target smaller companies for better growth.

**Value Stock Subaccount**

The objective of a value stock subaccount is to invest the majority of the assets in common stocks of companies that are under-valued in the market. Value stocks often perform well in periods where growth stocks perform poorly.

**OTHER SUBACCOUNTS**

Many other types of subaccounts are available in the variable annuity market of today.

**Global Subaccounts**

Global and international accounts are very popular today. Global funds seek to buy debt and equity issues from other prospering or developing nations, in addition to those of the United States. A variation of these funds is the international fund, which invests all of its money outside of the United States. Many advisors believe that the diversification global and international funds offer will be very desirable for long-term investors. Contract owners should be aware that most global and international funds impose higher than average management fees and expenses.

**Precious Metals Subaccounts**

Precious metals accounts are comprised of equity and debt instruments of companies involved in gold and other precious metals.

**Social and Environmental Subaccounts**

Social and environmental funds invest in companies that are socially or environmentally responsible.

**Index Subaccounts**

The index fund attempts to "mirror" a major index-such as the S&P 500 and match its gains and losses. Some insurers include index options in their general accounts, providing both index returns and minimum guarantees of interest.

e. **Risk-based**

**RISK-BASED**

**Money Market Subaccount**

The objective of this subaccount is to provide the highest current return possible while preserving principle and maintaining liquidity. A money-market fund invests in very secure, short-term investments. Typically, maturities do not exceed one year. The fund usually consists of CDs, Treasury bills and commercial paper, which are short-term notes usually issued by large, financially secure corporations. Because of the short duration of the portfolios, interest rates on money-market funds usually are low when compared to other long-term investments.

Agents should be aware that although funds in this subaccount may preserve principle, surrender charges and taxes diminish the liquidity.

**Bond Subaccount**

The objective of a bond subaccount is to invest the majority of funds in corporate bonds or other debt investments including government or corporate bonds, both foreign and domestic. In a conservative bond fund versus a high yield bond fund, the underlying quality of the bonds will be strong.

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Bond accounts tend to attract individuals seeking income from the variable annuity. Bond funds invest exclusively or primarily in debt securities.

Bond funds are much more subject to interest rate risk than stock and growth funds. As interest rates rise, the stock market may or may not respond negatively, but the value of a bond fund goes down and corresponding income is more susceptible to inflation.

**High Yield Bond Subaccount**

The investment objective of a high-yield bond subaccount would differ from a normal bond subaccount, since the underlying investments are lower rated bonds, and thus more risky. High risk bond funds purchase lower grade debt security than a more traditional bond fund, which may buy higher quality, lower yielding bonds.

**Fixed Rate Subaccount (Section 10127.10 Of The CIC)**

Funds in the fixed account are held in the general account of the insurance company. Insurance companies offering variable annuities usually offer a fixed interest option. The objective of the fixed rate subaccount is to generate conservative and safe returns. The fixed rate subaccount offers a fixed interest rate that is guaranteed for one or more years. The fixed account in a variable annuity may also provide a minimum guaranteed interest rate.

### 2. Charges and fees

**CHARGES AND FEES**

**Mortality and Expense Charges**

The first fee typically imposed by an annuity will be what's known in the industry as a "mortality and expense" (M&E) charge. This fee pays for the insurance guarantee, commissions, selling, and administrative expenses of the contract. In general, these fees in a variable annuity will be charged as a percentage of the average value of the investment. According to the National Association of Variable Annuities (NAVA), the industry average M&E in 1997 was 1.15%. In a fixed annuity, these charges are usually incorporated in the insurance company's determination of the periodic interest rate or the annuity payment amount during the distribution phase. Some of the newer approaches to defining and periodically resetting the death benefit under a variable annuity contract are more expensive for the insurer. Consequently, the contracts that offer these benefits assess an additional mortality charge. Some carriers allow each buyer to choose between the traditional death benefit reset and the enhanced benefit reset at the higher cost. Keep in mind that the mortality and expense charge, as well as the administrative service charges, are assessed only against the funds held in the separate account; they never are assessed against funds held in the general account.

Mortality and expense risk charges are computed on and deducted from the net value of the separate account each day, but they are usually expressed in an annual percentage. It is usually shown as a combined charge, though many companies also show the breakdown into the mortality and expense elements. The combined percentages vary widely, ranging from about .5% for some companies to over 2% for others. The company's mortality risk comes from two sources. One is the guaranteed lifetime payment options in the contract. The payment amounts are based on mortality statistics, but there is a chance that annuitants as a whole will live longer than the statistics indicate, making those lifetime guarantees more expensive to the company. The other source of mortality risk is the death benefit that the company guarantees to the beneficiary in the event of the owner's death prior to the annuity starting date. It is possible for the death benefit guaranteed by the company to be greater than the value of the separate account at the time of the owner's death. The mortality risk charge compensates the company for that possibility. The source of expense risk is that it may cost more to administer and distribute the contracts than the company anticipated. The company guarantees that its mortality and expense risk charges will not increase.
Other Fees
In addition to the mortality and expense charge, variable annuity contracts typically contain fees such as policy administration charges and investment management fees. The fees are listed and disclosed in full detail in the prospectus. These are some of the more common fees in addition to mortality and expense fees:

Administration Charges

An **administrative service charge** usually is expressed as a percentage of the funds invested in the separate accounts. It covers the cost of transferring funds from one separate account option to other separate account options or to the general account fixed option. It also covers the issuance of quarterly, semiannual or annual statements, depending on the insurer. Finally, it covers the costs of tracking deposits and the issuance of confirmations when monies are received or withdrawals are made. (This includes the processing of loans for variable annuities that are used to fund qualified plans such as 403(b), 401(k) or 401(a) plans.) This fee is calculated and deducted daily on an annualized basis from all monies in the separate/variable accounts within the contract. Most VA contracts stipulate that this fee will not increase. The insurer may deduct charges to cover record-keeping and other administrative expenses. This may be charged as a flat account maintenance fee (perhaps $25 or $30 per year) or as a percentage of the account value (typically in the range of 0.15% per year).

Contract Maintenance Charge

A yearly **maintenance charge** commonly is assessed to cover the administrative expenses associated with the variable annuity contract. This charge, usually applied at each contract anniversary date and upon surrender of the contract, covers the cost of issuing the policy, as well as other administrative costs. Some insurers waive this charge if the contract value is greater than a specified level. Many companies assess a policy maintenance fee to pay for the expenses of maintaining the contract on their books. This is often a flat dollar amount of between $25 and $40, assessed once each year. This charge may also be deducted on a quarterly basis from each separate account investment option to which the owner has allocated funds.

Management Fees

**Management fees** on subaccounts are assessed by variable annuities, and they are the same as an investment manager's fees in a mutual fund. These fees will vary depending on the various subaccount options within the annuity. In general, they will be somewhat less than those charged by a managed mutual fund within the same investment category -- though not necessarily. According to NAVA, the 1997 industry average for subaccount management fees was 82 basis points, or 0.82%. Management fees are the costs of managing a portfolio in a separate account. Management fees vary widely, depending on the type of fund. The range is generally from 25 percent of assets under management for a money-market fund to more than 1 percent for some global or international funds. The difference reflects the level of expertise needed to manage the fund and the higher costs associated with the start-up of any fund. The management fees and expense charges are *not* assessed directly to the contract owner. These charges are assessed against the subaccount values and are subtracted before calculating the accumulation unit value for the subaccount. Consequently, they affect the underlying fund’s performance.

FEES FOR SPECIAL FEATURES

Charges for special features, such as a:

- Stepped-up death benefits;
- Guaranteed minimum income benefits;
- Long-term care insurance; or
- Principal protection.

A description of the charges can be found in the prospectus of any variable annuity.
SURRENDER CHARGES

With most variable annuities currently marketed, rather than deducting the sales charge up-front, 100 percent of a contract owner's funds are available for immediate investment. In return, to offset commissions that insurance companies pay to the agents who sell VA contracts, the companies assess surrender charges to contract owners who liquidate their contracts during the first several years. These surrender charges also may be called contingent deferred sales charges. The charge is assessed against any withdrawal that does not meet the contract's free withdrawal provision.

Surrender charges in variable annuities do not usually apply at death, during the free-look, or to penalty-free withdrawals. When surrender charges are applied, the charge is made against premium contributions instead of account values. The length and amount of surrender charges is important to consider when evaluating suitability. Selling an annuity with surrender charges that last longer than the contract owner's anticipated need for funds is not suitable.

3. Dollar cost averaging

DOLLAR COST AVERAGING

Dollar cost averaging (DCA) is a method of purchasing accumulation units within a variable annuity by making regular, level investments over a period of time. By using DCA, the contract owner can keep his or her average cost below the market. With the same amount invested on a regular schedule when the market price is higher, fewer shares will be purchased. When the market price is lower, more shares will be purchased. With deferred annuities, dollar cost averaging during the accumulation phase is virtually automatic. Where the deposit is a lump sum, dollar cost averaging is accomplished by allowing a portion of the investment to earn a fixed interest rate and systematically transferring portions into sub-accounts each month.

Dollar cost averaging does not offer a guarantee of gain or a guarantee against loss but over time it helps to average out the highs and lows in the market.

4. Death benefit guarantees (Section 10168.4 of the CIC)

DEATH BENEFIT GUARANTEES (Section 10168.4 of the CIC)

California, like many states, has passed minimum nonforfeiture laws. The purpose of such laws is to make sure that contract owners receive something when and if he stops making premiums. Most annuity contracts provide cash surrender values benefits prior to maturity.

California law states that in no event shall any cash value surrender benefit be less than the minimum nonforfeiture amount at that time. And, the death benefit under such contracts shall be at least equal to the cash surrender benefit.

In fixed and equity-indexed annuities, the death benefit is usually the accumulated value or the surrender value. With variable annuities, due to the investment risk of the subaccounts, the death benefit fluctuates and could potentially be far less than the amount invested in the contract.

The Guaranteed Minimum Death Benefit is generally the greater of either the total amount of premiums, less withdrawals, or the current value of investments. Agents should carefully read the contract language for the variable annuity chosen to find out exactly what type of death benefit the company offers. Most variable annuity contracts available today also offer an enhanced or “stepped-up” death benefits by guaranteeing that the death benefit will never be lower than the highest account value on any contract anniversary. The stepped-up death benefit may also include any premiums paid (minus any withdrawals taken) since that time.
5. Living benefit guarantees

LIVING BENEFITS GUARANTEES

A new trend in the VA market are Guaranteed Living Benefits (GLBs). Designed to ensure some minimum contract amounts, these guarantees generally take one of these forms:

GUARANTEED MINIMUM ACCOUNT VALUE (GMAV)

The Guaranteed Minimum Account Value (GMAV) ensures that the contract's account value will be no less than a specified percentage of premiums paid after a specified number of years, such as 8 or 10. The amount of the guarantee exceeding the account value at the end of the specified period is added to the account value and the contract continues, with or without a new guarantee period. Annuitization is not required to realize this benefit.

GUARANTEED MINIMUM INCOME BENEFIT (GMIB)

The most common living benefit is the Guaranteed Minimum Income Benefit (GMIB) which ensures that a minimum amount will be available to convert to annuitized income at rates specified in the contract. Consequently, a minimum income benefit is guaranteed. Risk to the insurer is at least partly managed by making the benefit contingent upon annuitization.

GUARANTEED MINIMUM INCOME PAYMENTS (GMIP)

Guaranteed Minimum Income Payments (GMIP) ensure that each annuitized income payment the annuitant receives under variable annuitization will never be less than a certain percentage of the first payment. This benefit has been recently added to immediate variable annuities, to help limit the possible fluctuation of monthly variable payments.

GUARANTEED MINIMUM WITHDRAWAL BENEFIT (GMWB)

Allows for a certain minimum amount that may be withdrawn from the annuity, usually over a set period of time.

GUARANTEED MONTHLY INCOME BENEFIT RIDERS (GMIB)

Regardless of how the subaccounts perform, this rider guarantees a competitive interest rate for the full term of the annuity provided the owner annuitizes upon maturity. This rider can be beneficial for both preretirees and seniors, since it adds a level of safety to the contract.

GUARANTEED RETIREMENT INCOME BENEFIT (GRIB)

One special type of variable annuity is the living benefit annuity, also known as a Guaranteed Retirement Income Benefit. The best living benefit annuities guarantee a minimum return over seven years, or the highest attained value on each anniversary during the surrender period, whichever is greater. In exchange for this living guarantee, the living benefit annuity has a surrender charge, or penalty for early withdrawal, no up-front bonus, and a slightly higher annual fee.

E. Identify and discuss indexed annuities

THE EQUITY Indexed ANNUITY

- Interest rates determined by changes in a major market index (i.e. S&P 500)
- Minimum interest rates are guaranteed for the policy duration
- Principal is not subject to risk

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The **Equity-indexed annuity (EIA)** is a fixed annuity that credits interest based on changes in a major market index, like the S&P 500. If the index increases, then some or all of that increase in credited to the annuity. If the index decreases, the value of the annuity does not fall. The principal and all previously credited interest is preserved. The least an equity-indexed annuity can earn is 0%.

The returns on EIAs are linked to an equity index, such as the S&P 500 index. However, the annuity is not actually invested in the stocks making up the index. Like fixed annuities, the returns to EIAs are paid from the insurance company’s general account. However, the amount allocated to the EIA is based on some percentage of the appreciation in the reference index, subject to annual caps. If the index declines in value, a minimum guaranteed amount is credited to the EIA. In this way, EIAs provide the upside potential of the equity markets with the downside protection of more conservative general account investments.

Equity-indexed annuities offer consumers a potentially higher rate of return than a traditional fixed annuity, but without the downside risk of variable products. Equity-indexed annuities (also known as EIAs) are relatively new. The first equity indexed annuity became available in the early 90's as a product that allowed consumers to participate in the stock market's upside without subjecting them to its potential downside. Since their introduction, these products have continued to gain popularity and sales are in the billions of dollars annually. The theory behind all indexed annuities is virtually the same - to offer market-linked growth without the associated risk. There are, however, many different designs in the marketplace. This makes it extremely important for agents to thoroughly understand and explain to their clients contracts they sell.

Equity-Indexed annuities provide a minimum guaranteed interest rate with excess interest crediting based on the movement of an external index. Equity index annuities share the same features as other fixed annuities:

- Tax deferral of interest compounding inside the annuity
- Lifetime income options
- Minimum interest guarantees
- Probate free death benefit if a beneficiary is named
- Interest earnings are often available through free withdrawals
- Regulated by an insurance product, not a security
- Withdrawals subject to IRS "premature distribution" rules
- Surrender charges

The original principal and previously credited interest are not subject to market risk. Even if the index declines the individual would receive no less than their original principal back if they decided to cash in the policy at the end of the surrender period.

**THE INDEX**

Index annuities may base the crediting of excess interest on movements of the S&P 500, Dow Jones Industrial Average, NASDAQ 100, Russell 2000 or other indices that are also used. Unlike an equity index mutual fund neither dividends nor capital gains are included in the index annuity calculation. No index-linked product is sponsored, endorsed, sold or promoted by any index.

Some companies have developed products with a variety of index options, including a traditional fixed interest rate strategy. By offering variety, the consumer can elect to allocate their deposit between the index options most suited to their needs. For flexibility, products typically allow for re-allocation among the indices each anniversary. When someone buys an equity-indexed annuity they own an insurance contract. They are not buying shares of any stock or index. Since an equity indexed annuity (EIA) is a fixed annuity it does not require a securities license to sell. Due to the unique nature of the EIA with its principal protection and index-linked returns, an EIA may be more appealing than standard fixed annuities without the market risk of variable annuities or mutual funds, particularly for those seeking a stable retirement income that can keep up with inflation. Since the EIA allows for protection of principal in down markets.
and provides for a zero percent return instead of a negative return during market declines, an EIA is ideal for clients who would like to participate in market returns yet are uncomfortable with market risk. As people age, inflation continues to erode the buying power and savings of clients. Over time, the highest investment returns have resulted from the equity markets. With the uncertainty of the stock market and low interest rates, clients are seeking safe alternatives to provide returns immune from market and inflation risks.

WITHDRAWAL PRIVILEGES

Most EIAs offer a 10–20 percent standard withdrawal feature while providing a nursing home or terminal illness waiver that may allow for a substantial or complete withdrawal without penalty. Typically most contracts allow for full contract value without penalty upon death of the annuitant.

TERM

The index term is the period over which index-linked interest is calculated. The interest is credited to the annuity at the end of a term. Terms are generally from one to ten years, with six or seven years being most common. Some annuities offer single terms while others offer multiple, consecutive terms. If the annuity has multiple terms, there will usually be a window at the end of each term, typically 30 days, during which clients may withdraw their money without penalty. For installment premium annuities, the payment of each premium may begin a new term for that premium.

INTEREST COMPOUNDING

It is important to know whether the annuity pays compound or simple interest during a term. While an annuity that pays simple interest may earn less, it may have other desirable features, such as a higher participation rate. To better understand the mechanics of an equity indexed annuity, agents need to understand the major crediting methods used to calculate index-linked returns in order to evaluate potential returns for a contract owner. On a traditional fixed annuity, the company declares an interest rate in advance and then credits that interest rate to in-force policies. In contrast, the interest rate credited to an equity-indexed annuity is the result of growth in an index, less fees taken by the insurance company. If the index goes up, the annuity is credited with at least a portion (from 60% to 110%, depending on the contract) of the increase. If the index goes down, however, neither the original principal nor any interest previously credited to the annuity is reduced.

The “indexing method” means the approach used to measure the amount of change, if any, in the index. There are several methods for determining the change in the relevant index over the period of the annuity. These varying methods impact the calculation of the amount of interest to be credited to the contract based on a change in the index. Some of the most common indexing methods include Point-to-Point, Monthly Averaged and High Water Mark.

| 1. | Primary interest crediting strategies |

INTEREST RATE CREDITING STRATEGIES

Modern equity index annuities are currently use the Standard & Poor’s 500 Composite Stock Price Index more commonly known as the S&P 500 Index. This index is a widely recognized measure of equities in the US stock markets.

While the S&P Index is the most widely used index today agents should also be familiar with other indexes that are and can be used. Some of these other indexes include the following:

- Standard & Poor 100 also known as the OEX Index
- S&P 400
- Nikkei National Index which represents the Tokyo stock exchange
- DAX Index which represents the German Exchange
- FTSE Index which represents the Financial Times Stock Exchange in London
A number of insurance carriers use some sort of internal operations to create the needed annuity returns using their own investment department instead of a major index. Others even may use a reinsurer to create the returns.

An equity-indexed annuity is different from other fixed annuities because of the way it credits interest to the annuity’s value. Equity-indexed annuities credit interest using a formula based on changes in the index to which the annuity is linked. The formula decides how the additional interest, if any, is calculated and credited. The 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 MONTHLY AVERAGING METHOD**

In some annuities, the average of an index's value is used rather than the actual value of the index on a specified date. The index averaging may occur at the beginning, the end, or throughout the entire term of the annuity.

Averaging at the beginning of a term protects consumers from buying their annuity at a high point, which would reduce the amount of interest they might earn. Averaging at the end of the term protects them against severe declines in the index and losing index-linked interest as a result. On the other hand, averaging may reduce the amount of index-linked interest earned when the index rises either near the start or at the end of the term.

The monthly averaging method takes the index value each month to arrive at an annual index average. The index average for the year is then compared to the index value at the start of the year. If the result is positive, the insurance company will then apply the participation rate, cap rate, and/or spread yield. For example, the ending index value of a monthly averaging method would be calculated as the last 12 monthly anniversary values added and divided by 12 to create an average annual value. In this case, averaging protects the contract holder from sudden declines in the index. This method helps prevent the risk of having no growth during years when the index may be volatile or suddenly turn downward just prior to the anniversary.

*The averaging method works best in volatile markets over a limited period of time.*

**THE POINT-TO-POINT METHOD**

Compares the change in the index at two discrete points in time, such as the beginning and ending dates of the contract term.

**Advantage:** May be combined with other features, such as higher cap and participation rates, that may credit you with more interest.

**Disadvantage:** Relies on single point in time to calculate interest. Therefore, even if the index that the annuity is linked to is going up throughout the term of their investment, if it declines dramatically on the last day of the term, then part or all of the earlier gain can be lost. Because interest is not credited until the end of the term, owners may not receive any index-link gain if you surrender your EIA early.

The index-linked interest, if any, is based on the difference between the index value at the end of the term and the index value at the start of the term. Interest is added to the annuity at the end of the term.

With this type of product, the value of the index to which the annuity is linked is marked at the time the contract is purchased and again at the end of its term. The difference in the index value between these
two points is the basis for the amount of interest that will be credited to the annuity. The two most common versions of this strategy are annual point-to-point and long-term point-to-point.

The major disadvantage of the point-to-point method is the risk that the index might be at a low point on the date the second point is recorded, resulting in the loss of unrealized index gains if the index sinks just prior to the second end point. In conditions where the index is either volatile or in a declining trend, equity-indexed annuities using a monthly averaging method may be more suitable than a point-to-point strategy.

*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.*

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### i. Annual point to point

**ANNUAL POINT TO POINT**

The *annual point-to-point* method uses an annual measure for calculating index returns. Whatever the market did in between is IRRELEVANT. Only the first and last day of the entire index term count.

An annual *point-to-point* would measure the index on the issue date and again one year later. With this option gains are credited to the annuity annually and the process of measuring index growth starts again each year.

### ii. Long term point to point

**LONG TERM POINT TO POINT**

A *long-term point-to-point* evaluates the growth the same way, except the measurements are separated by a longer horizon. For example, a three-year point-to-point means the first measurement is taken on the issue date and the second at the end of the third year. No interest is credited until the annuity reaches this second point, three years later. For example, the index value was at 100 on the first day of the period. If the index value was at 150 at the end of the period the gross index gain would be 50% (150-100/100).

The company would credit a percentage of this gain, by applying a *participation rate*. If the participation rate was 80% the index annuity would be credited with a total return of 40% interest (50% index gain x 80% rate) for the period. Regardless of which version of point-to-point is used, the difference between the two values (or points) represents the gain in the index before participation rate, cap rate and/or spread yields are applied.

### c. High water mark

**THE HIGH WATERMARK METHOD**

Looks at the index value at various points during the contract, usually annual anniversaries. It then takes the highest of these values and compares it to the index level at the start of the term.

**Advantage:** May credit more interest than other indexing methods and protect against declines in the index.

**Disadvantage:** Because interest is not credited until the end of the term, the owner may not receive any index-link gain if they surrender the EIA early. It can also be combined with other features; such as lower cap rates and participation rates that will limit the amount of interest they might gain each year.

A *high watermark* annuity measures the difference between the index value from the time the contract is purchased to the point when the index reaches its highest level in the given term. In a five-year contract, for example, the highest of the index’s value on all five anniversary dates would be the high mark. Like point-to-point and monthly averaging, some percentage of the growth will be applied to the contract using a participation rate, cap rate, and/or spread yield.
The high-water mark method performs best when the market rises to a high level and then surrenders a significant portion of the gain over the remainder of the contract term.

The high-water mark represents less than one percent of sales and is not a major method used today.

LOW-WATER MARK

This is a variation of the high-water mark annuity. A low watermark product measures the difference in the index value between the anniversary date on which the contract reaches its lowest mark and the end of the contract's term. This difference is the basis for the amount of interest credited to the annuity.

d. Annual resets

THE ANNUAL RESET PROVISION

Compares the change in the index from the beginning to the end of each year. Any declines are ignored.

Advantage: The gain is "locked in" each year.

Disadvantage: Can be combined with other features, such as lower cap rates and participation rates that will limit the amount of interest gained each year. This design, in all its variations, counts gains by the year, recognizes those gains, and locks them in so they are not lost in market downturns. All three zones of gain are counted.

An important feature found in many equity-indexed annuities is the annual reset provision. With an annual reset design, the index to which the annuity is tied is marked at the beginning and end of each contract year. The difference in the index value each year is the basis for the amount of interest credited to the product. Any declines are ignored. The annual reset provision has many benefits for seniors. First, the annual reset provision locks-in gains each anniversary and protects all previous years' interest from being lost in subsequent years. The annual reset provision also provides new growth potential each year by resetting the index starting point. This presents a new opportunity for gain after the index suffers a severe downturn the previous year by using the lower value as its reset point for the year ahead. Most seniors prefer fixed annuities to variable annuities partly because they can access income through interest withdrawals. With equity-indexed annuities, the annual reset provision is an important feature to evaluate when determining suitability for seniors. Without it, index gains cannot be credited annually and are not available to withdraw.

The annual reset method works well under volatile market conditions and has become popular in the past two years. This method also provided the best index participation potential when taking out periodic or systematic withdrawals.

e. Combination methods

EQUITY-INDEXED ANNUITIES MAY OFFER A COMBINATION OF METHODS

In an effort to give consumers even more choice, companies are assembling combination contracts that use many of the methods described above.

Each of the interest rate crediting strategies reacts differently to the market's performance. Some products offer a combination of interest rate crediting strategies. Many of today's products include both monthly averaging and point-to-point methods. This offers the consumer the flexibility to decide how funds will be allocated at issue and funds can be reallocated each anniversary between methods and index options.
2. Spreads

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.

Some EIAs use a spread, margin or asset fee in addition to, or instead of, a participation rate. It is stated as a percentage deduction from the amount of indexed interest and it is used to cover the expense of purchasing index options and other underlying expenses. This percentage will be subtracted from any gain in the index linked to the annuity. For example, if the index gained 10% and the spread/margin/asset fee is 3.5%, then the gain in the annuity would be only 6.5%.

3. Cap rates

CAP RATES

A cap rate is the explicit maximum account value percentage increase allowed. The cap for an annual reset product is the maximum account value percentage increase allowed for a given policy year. A cap serves to set an upward limit on the client’s Index Benefit.

Some equity-indexed annuities place a cap on the rate of interest that may be credited. Even if reference to the index would produce a higher rate, the rate credited to the annuity will not exceed the cap. Not all equity-indexed annuities have caps. They are often used in conjunction with a participation rate and are common in EIAs with an annual reset design. Annuities that have a cap may also have a higher participation rate.

4. Participation rates

PARTICIPATION RATES

Participation rates represent the percentage of the increase in the index that will be credited to the accumulation value, which may be subject to the cap in some of the contracts. The percentage stated (participation rate) is multiplied by the amount of increase in the index value to determine the indexed interest. For example, the insurance company may set the participation rate at 80%, which means the annuity would only be credited with 80% of the gain experienced by the index. When the S&P 500 value increases 10 percent, an EIA with an 80 percent participation rate will receive indexed interest credit of 8 percent. The participation rate may vary greatly from one annuity to another and from time to time within a particular annuity. It is important for agents to be able to explain to clients how their annuity's participation rate works with the indexing method. A high participation rate may be offset by other features, such as averaging, or a point-to-point indexing method. On the other hand, an insurance company may offset a lower participation rate by also offering a feature such as an annual reset indexing method.

5. Minimum guaranteed interest rate

MINIMUM GUARANTEED INTEREST RATE

One of the EIA features that is most commonly misunderstood is the minimum contract value. This value is an underlying secondary guarantee or "safety net" that ensures a guaranteed minimum cash value is available to the consumer.

The minimum contract value is guaranteed regardless of how the index performs. (Index performance is reflected through index increase credits to the current accumulation value.) If the index stays flat or declines over the entire term of the contract this minimum contract value comes into play. Of course, the
The likelihood that the Index will remain perfectly flat or consistently decline over a long period of time is statistically small. However, this guarantee exists to accommodate that scenario.

Some contracts "top up" the minimum contract value at the end of a term to equal the current accumulation value as of the just ended term. This effectively increases the minimum contract value guarantee to reflect previously earned index credits.

In and of itself, the minimum contract value is not a particularly meaningful feature with which to compare the competitiveness of a product. In reality, this value will only be meaningful:

- Upon early surrender.
- If the index is flat or declines over the entire term.

Minimum guaranteed interest rates afford seniors a greater peace of mind when purchasing an annuity. The equity-indexed annuity, like other fixed annuities, also promises to pay a minimum interest rate. The rate that will be applied will not be less than this minimum guaranteed rate even if the index-linked interest rate is lower. The value of the annuity will never drop below a guaranteed minimum. The guaranteed value is the minimum amount available during a term for withdrawals, as well as for annuitization and death benefits. The insurance company will adjust the value of the annuity at the end of each term to reflect any index increases. With equity-indexed annuities, bonds support the minimum guaranteed rate, but options in an index are purchased to enhance the credited rate. The minimum guaranteed interest rate accumulates separate from index account. At the end of the contract term, the client receives the greater of:

- the minimum guaranteed value or
- the index value.

Not both!

The client receives the greater of these two values when the annuity reaches its term or is surrendered prematurely. A variety of methods are used to calculate the minimum guaranteed interest rate. Usually, it is calculated as a percentage of the premium deposited. Different methods of calculating the minimum guaranteed values produce a variety of results. Agents must understand and be able to explain to clients how these variations impact minimum guaranteed values.

**THE NAIC MODEL FOR MINIMUM GUARANTEED INTEREST RATES**

Some companies are now using the NAIC's Interest-Indexed Annuity Contract Model Regulation as the method for setting the minimum guaranteed interest rates. Since the State of California has adopted this model in Section 10168.25 of the California Insurance Code, agents should be familiar with it.

Under the traditional approach, the guaranteed minimum rate remains constant during the annuity's term. With the NAIC's Model, the minimum guaranteed interest rates can fluctuate within a range each anniversary, based on the interest rates of an external reference. For the insurance company, this approach allows the company to maintain adequate cash flows during times when prevailing interest rates may be low; but for the agent it adds much more complexity to the guaranteed minimum interest rate. Agents who represent contracts using this method should be sure they understand, and can explain to their clients, how this will affect the growth of their annuity.

### 6. Impact of premature surrender charges

**PREMATURE SURRENDER CHARGES**

If a client withdraws all or part of the value in his annuity before the end of the term, a withdrawal or surrender charge may be applied. A withdrawal charge is usually a percentage of the amount being
withdrawn. The percentage may be reduced or eliminated after the annuity has been in force for a certain number of years. Sometimes the charge is a reduction in the interest rate credited to the annuity.

Some annuities credit none of the index-linked interest or only part of it if the owner takes out all of their money before the end of the term. The percentage that is vested, or credited, generally increases as the term comes closer to its end and is always 100% at the end of the term.

Like fixed and variable contracts, EIAs may have a limited "free withdrawal" provision. This lets them make one or more withdrawals without charge each year. The size of the free withdrawal is limited to a set percentage of their annuity’s guaranteed or accumulated value. If they make a larger withdrawal, they may pay withdrawal charges. They may also lose index-linked interest on amounts withdrawn.

Most annuities waive withdrawal charges on withdrawals made within a set number of days at the end of each term. Some annuities waive withdrawal charges if they are confined to a nursing home or diagnosed with a terminal illness. The client may, however, lose index-linked interest on withdrawals.

Insurance companies who offer deferred annuities impose a penalty for withdrawing funds prematurely, called a surrender charge. Pursuant to Sections 10127.12 and 10127.13, carriers are required to disclose that surrender charges exist on the cover of the policy, in addition to sending statements to the contract owner that illustrate the surrender values.

Surrender charges are assessed to help a company recover costs including commissions in the event a policyholder withdraws the funds prior to the term. There is a direct correlation between commissions and surrender charges: The higher the commission – the higher the surrender charges. Like fixed annuities, the surrender charges in equity-indexed annuities are stated as a percentage and usually vanish over time. When an equity-indexed annuity is surrendered prior to its term, the surrender charge is assessed against the index value and then compared to the minimum guaranteed contractual value. Whichever value is greater becomes the surrender value of the contract. Agents should carefully evaluate the death benefit provision when recommending equity-indexed annuities to a senior. Some products assess a surrender charge at death unless the beneficiary agrees to take the proceeds over a 5-year period. This difference can be dramatic especially for beneficiaries who may need the funds in the annuity right away to pay for obligations of the deceased. Agents should make sure they understand the liquidity provisions of the equity-indexed annuities they sell. Some equity-indexed annuities offer no access to cash values during the policy term, which may last for several years. Others may offer only limited access, while some offer withdrawals on a basis similar to other fixed annuities.

### a. Two-tier annuities - define concepts

**TWO-TIERED ANNUITIES**

A Two-Tiered Annuity is an annuity which retroactively credits a lower rate of interest on accumulated values if the contract is surrendered rather than annuitized.

Two-tiered annuities offer relatively high rates, but only if the owner holds the contract for a certain number of years and then annuitizes it. If the annuity is surrendered at any point, interest credited to the contract is recalculated from the contract's inception using a lower tier of rates. The contract owner gets one tier of interest rates by staying with the contract through annuitization and another, lower tier of rates if he or she does not. These products are used most often in the tax-sheltered annuity market with teachers. Agents who sell two-tiered annuities must make sure that clients know how the product works and are prepared to commit themselves and their beneficiaries to the annuity for a long term.

### 7. Charges and fees

**EQUITY INDEXED ANNUITY CHARGES & FEES**

Other than surrender charges most equity indexed annuities have no associated fees or charges. However, where participation rates are involved, administrative fees may be charged ranging from 1
percent to 2.5 percent annually. Contracts with less than 100 percent participation rate, however, typically do not charge such fees.

EIAs are long-term investments. Getting out early may mean taking a loss. Many EIAs have surrender charges. The surrender charge can be a percentage of the amount withdrawn or a reduction in the interest rate credited to the EIA.

Agents should determine what surrender charges may apply and how long the surrender charge period lasts in relation to the indexing period. Often, surrender charges apply for the length of the policy term, at which point there is a "window" during which the owner can withdraw the annuity funds or renew the annuity for another term at the participation percentage declared by the company for that term. In addition to the surrender and withdrawal charges and free withdrawals, there are additional considerations for equity-indexed annuities. Some annuities credit none of the index-linked interest or only part of it if clients take out money before the end of the term. The percentage that is vested, or credited, generally increases as the term comes closer to its end and is always 100% at the end of the term. Also, any withdrawals from tax-deferred annuities before clients reach the age of 59½ are generally subject to a 10% tax penalty in addition to any gain being taxed as ordinary income.

F. Identify and discuss available riders

ANNUITY RIDERS

In an effort to be a competitive as possible, many annuity companies offer a myriad of annuity rider options. Some are available only at the time the contract is issued, others can be added later.

Insurers have developed a variety of riders adding additional features to make annuities more appealing to consumers. The riders discussed in this course are Life Insurance Riders, Long-Term Care Riders, and Guaranteed Monthly Income Benefit Riders. Many other riders may be available.

1. Life insurance riders

LIFE INSURANCE RIDERS

Life insurance riders help beneficiaries offset the income tax due on annuity gains. They are especially suitable for seniors who purchase annuities with no intent to access the funds, but want the proceeds passed on to children and grandchildren upon their death. The death benefit can increase based on increases in the account value. Typically, this is measured by recording the highest value on any contract anniversary.

Under this option, an increasing term rider is attached to the annuity contract. As the annuity credits its interest rates, some portion of the account value increases are withdrawn to apply as premiums on the ever increasing amount of term insurance. At the annuity owner's death, the beneficiary receives, tax free (or tax reduced) the death benefit from the annuity plus that from the term rider. Because the annuity's benefit is equal (or close to) to the amount of the original principal, there is no taxable gain. The term rider pays income tax free death benefits.

Income taxes are payable on amounts withdrawn from the annuity to pay the insurance premiums. However, these amounts are minor compared to what beneficiaries would pay were they to receive the traditional gain from the annuity.

2. Long term care benefits riders

LONG TERM CARE RIDERS

Insurers are offering riders that pay LTC benefits up to a maximum monthly limit for a certain period of years. Investors designate a portion of initial purchase payments to cover the benefits. The benefits wouldn’t be reported as taxable income, in line with the Pension Protection Act of 2006. These policies
function more like *long term care policies*. More traditional style contracts included long-term care riders that paid benefits when a serious illness occurs, even when no nursing home care is needed. For example, victims of strokes, heart attacks, cancer, coronary artery surgery, and renal failure can collect benefits while they are still living. Sometimes the policy holder can receive as much as 25 or 50 percent of the policy's face value up front, rather than in regular monthly payments.

LTC riders on annuity contracts are usually more limited than conventional LTC policies on the market today and may also be subject to different, often stricter, coverage triggers. When working with seniors, a number of factors should be considered when evaluating annuities with LTC riders. **Non-medically underwritten** riders cannot be accessed until the contract has been in force long enough to protect the carrier from the affects of adverse selection, commonly five to seven years.

- With a non-medically underwritten rider your client's life expectancy should be longer than the waiting period on the rider or the rider may not be suitable since the likelihood of accessing benefits diminishes.
- If your client is considering an annuity with a LTC rider in place of conventional long-term care insurance, take the time to explain the differences between the two.
- LTC riders should not be sold as substitutes for LTC policies.
- These riders do not participate in California's Partnership for Long-Term Care Program.
- Clients who purchase an annuity with a long-term care rider will not be eligible for expanded asset protection from Medi-Cal, as well as other consumer safeguards in a Partnership Policy. For more information: www.dhs.ca.gov/cpltc

### TERMS OF RIDERS

These riders are designed to provide benefits over and above the monthly payments received from an annuity. 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 the contract definitions.

There are generally two types of long-term care riders - **underwritten** and **non underwritten**. Underwritten riders typically offer richer benefits closer to those found in stand-alone LTC policies than non-underwritten riders.

#### Medically Underwritten Long-Term Care Riders

When a claim occurs, the insured's annuity value is used to fund qualified LTC expenses. Most underwritten riders require the annuity's value to be completely used up before access to the rider's benefit can begin. Once the annuity value has been depleted, the rider continues paying for LTC expenses, subject to the maximum benefit of the rider. Underwritten riders, similar to conventional long-term care insurance, require detailed applications and face-to-face assessments to establish acceptability. Underwritten riders also utilize industry standard policy provisions and definitions such as benefit triggers, elimination periods, benefit maximums and inflation protection.

The long-term care provisions of the policy are generally triggered by a physician's certification that the insured is chronically ill and unable to perform a specified number of daily living activities. The long-term care provided may involve a deductible period, but it can be defined to cover care in an assisted living facility or home health care as well as confinement in a nursing home. LTC riders also cover both Alzheimer's Disease and similar forms of irreversible mental impairment.

#### Non-medically Underwritten Long-Term Care Riders

Non-medically underwritten long-term care riders are more limited in the scope of benefits they contain, but they appeal to consumers who cannot purchase medically underwritten long-term care insurance due to medical conditions. With annuities that offer non-medically underwritten riders, a cost for the rider is
deducted from the annuity's cash value to create a separate fund for long-term care expenses. Funds withdrawn from the long-term care fund do not deplete the annuity account. Provided the insured meets the benefit triggers and satisfies the elimination period (if any), a percentage of the long-term care account may be accessed. Benefits are usually further limited by a maximum benefit period.

b. Differentiate between crisis waivers and long term care riders

LTC RIDERS COMPARED TO CRISIS WAIVERS

Long-term care insurance riders are different than crisis waivers. An annuity containing a long-term care insurance rider provides separate insurance benefits which cover expenses across the long-term care continuum including nursing home care, assisted living facility care, home and community-based care. A nursing home crisis waiver merely eliminates surrender charges upon withdrawal of funds from the annuity in the event a nursing home admission occurs after the annuity was purchased. No insurance benefit is provided, and the crisis waiver does not apply to all aspects of the long-term care continuum such as home care, assisted living or adult day care.

In California, agents who sell long-term care insurance policies, including life insurance and annuity contracts containing long-term care insurance riders, are required to complete additional training as a prerequisite. Agents selling policies with LTC waivers would not be required to take this special training.

3. Skilled nursing facility rider

SKILLED NURSING HOME RIDERS

A skilled nursing home rider would provide money for nursing home benefits . . . normally two percent of insurance coverage per month. By this rule, a $100,000 policy would pay $2,000 per month. However, if the policy is over $150,000, the policy holder may get less than two percent.

Most long-term care riders will pay for skilled care or intermediate care nursing home stays. However, some riders do not pay for custodial care. Others will pay only after a specified number of days in a hospital or a specified number of weeks in a skilled care or an intermediate care home. The problems with funding long term care coverage through an accelerated death benefit policy are obvious: Benefits may be lower than a stand-alone policy, benefit triggers can be tricky and there is typically no inflation protection other than by expensive inflation riders.

Furthermore, the death benefits that could have gone to an insured’s estate are usually “eaten-up” in long term care costs thus defeating the purpose of buying a life insurance policy. Also, agents must be sure to differentiate between actual coverage and a simple crisis waiver, which allows the waiver of certain fees should a special illness develop.

SAMPLE WORDING FROM A LONG-TERM CARE RIDER:

CONDITIONS OF ELIGIBILITY FOR BENEFITS

We will pay benefits for Long Term Care Facility confinement, Assisted Living, Home Health Care and Adult Day Care services for the person who is the Insured under the Certificate. It does not cover any other person.

When Benefits Begin: Benefits begin after Insured has been confined in a Long Term Care or Assisted Living Facility or received Home Health Care or Adult Day Care services for 90 days. The first 90 days of confinement or services is the Elimination Period. No benefits are payable for confinement or services during this time. This 90 day period need not be continuous. It must, however, be entirely within one Benefit Period.
Conditions for Payment: For benefits to be payable, the Insured must:

- Require assistance in two or more of the Activities of Daily Living; or
- Have Cognitive Impairment.

AMOUNT OF BENEFIT

Long Term Care Facility and Assisted Living Benefit: For each Benefit Period the monthly Long Term Care Facility or Assisted Living Benefit is the greater of 4% of the Face Amount or 4% of the Death Benefit Amount at the end of the Elimination Period for that Benefit Period.

We will pay the Long Term Care Facility or Assisted Living Benefit for each month the Insured remains confined in a Long Term Care or Assisted Living Facility, following the Elimination Period, for up to 25 months for all Benefit Periods combined.

For a partial month of confinement, benefits are payable on a pro-rata basis; One-thirtieth (1/30th) of the monthly benefit will be paid for each 24 hour day of confinement. If a new confinement is within the same Benefit Period as a previous confinement, benefits are resumed at the previous amount of monthly benefit.

Home Health Care and Adult Day Care Benefit: For each Benefit Period, the monthly Home Health Care or Adult Day Care Benefit is the greater of 4% of the Face Amount or 4% of the Death Benefit Amount at the end of the Elimination Period for that Benefit Period.

We will pay a benefit for Home Health Care or Adult Day Care for each month the Insured receives such care, following the Elimination Period, for up to 25 months for all Benefit Periods combined.

Benefits are payable on a pro-rata basis. One thirty (1/30th) of the monthly benefit will be paid for each day of Home Health Care or Adult Day Care.

Benefit Exceptions and Limitations

- Irrevocable Beneficiary: If the Certificate has an irrevocable Beneficiary(s), no rider benefits can be paid without the prior written consent of such Beneficiary(s).
- Indebtedness: In determining the monthly benefit amount payable, the Face Amount and Death Benefit Amount will first be reduced by the amount of any Indebtedness at the end of the Elimination Period.
- Assignment: Rider benefits payable are subject to and will be reduced by any assignment, or partial assignment of the Death Benefit Amount.
- Change in Amount of Benefit: After the start of the first Benefit Period the amount of benefit will be unaffected by changes in the Face Amount and Death Benefit Amount, except that if a Partial Surrender, a decrease in Face Amount, or a Certificate loan occurs at Your request, the amount of benefit for that Benefit Period will be redetermined. The revised benefit and future payments will be based on the Face Amount and Death Benefit Amount as they exist immediately following the Partial Surrender, decrease in Face Amount or loan.

4. Hospice rider

HOME HEALTH AND HOSPICE RIDER

Some innovative plans pay up to 100% of allowed charges for home health care and up to 100% for hospice care. Many, however, come with lifetime maximums that can be as low as $5,000.

Benefits are paid when the contract owner is receiving hospice care while confined to a licensed hospital, licensed convalescent care facility, skilled nursing facility, custodial care facility, or licensed hospice facility for 60 or more consecutive days.
LOAN PROVISIONS

Many annuity companies permit loans up to the contracts cash value. However, there are usually many statutory regulations, regarding maximum interest charged, repayment, disclaimers that the loan will offset any cash value or death benefit, etc.

Loan provisions are another means to access annuity funds. Loans on these annuities receive preferred tax treatment as well if they are structured and paid back according to IRS guidelines. Though loan provisions are usually found in most qualified annuities, some of the newer nonqualified annuities have also incorporated loan provisions. These loans are typically available to contract owners at a low cost. However, annuity loans are considered distributions from annuity contracts and therefore are taxable. If a loan is taken before the annuitant reaches age 59½, a 10 percent early withdrawal penalty also applies.

When an annuity is inside a qualified plan, these requirements are even stricter where loans are limited to ½ of the current present value with a maximum repayment period of 5 years. In addition, loans must have a level amortization (repayment) plan.
VI. QUALIFIED AND NON-QUALIFIED PLANS AND ANNUITIES

Annuity Taxation

It's essential for agents to understand the impact of annuity taxation on their clients and their beneficiaries because the agents must be able to recommend the proper retirement- or estate-planning option. Much of the planning focuses on the impact of taxes on the structure of the annuity contract.

Annuities may be a significant part of an individual's comprehensive financial plan. There are special income tax rules that apply to annuity contracts. This course provides a general discussion about taxes and annuities. Clients should consult a professional tax advisor to discuss their individual tax situation. Agents should not attempt to provide legal or tax advice unless they possess the credentials to do so.

A. Types of Plans

THE BENEFITS OF QUALIFIED PLANS

Qualified plans offer many advantages to Americans who want to save for their retirement.

- Earnings on contributions accumulate tax-deferred until distributions begin.
- All individual plans (except Roth IRAs) and employee contributions to employer-sponsored plans allow contributions to be funded with pre-tax dollars.
- Most qualified plans allow investors to change the amount of contributions made yearly, to account for changing financial circumstances.
- A variety of different financial instruments including stocks, bonds, mutual funds and annuities may be used to fund qualified plans.

Qualified plans are intended (receive tax-preferred treatment) as long-term investments. Qualified plans in general, are subject to the following restrictions:

- Contributions made to qualified plans are deductible up to specified limits. These limits are dictated by the plan and typically change yearly.
- Exceeding the plan's maximum contribution limits, usually carries penalties.
- 100% of the distributions from most qualified plans are subject to income taxation.
- Additionally, a penalty tax may apply if funds are accessed prematurely.
- The amount of tax varies depending on the plan type.
- Under specific circumstances the IRS will waive the penalty tax.
- At some point, the IRS requires that a minimum distribution must be taken from qualified plans.
- For employer-sponsored plans, distributions are generally required beginning April 1 of the year following retirement or age 70½, whichever is earlier.
- All other plans require distributions to begin April 1 of the year after the owner reaches age of 70½.

QUALIFIED VS. NONQUALIFIED ANNUITIES - TAXATION

A qualified annuity is an annuity purchased with before-tax dollars and receives tax benefits not available to a non-qualified plan, but is subject to very strict government regulations. The employer receives a deduction when contributions are made to the plan. At least 70% of non-highly compensated employees must be covered by the plan, and government-set vesting schedules must be followed. Earnings accumulate tax-deferred and will be taxable to the individual at the time of distribution. No income tax deduction is available for the employer at the time of distribution. Independent contractors or directors are not eligible for coverage under a QRP.

Qualified Plans and Annuities

A good place to start investing for retirement is with employer-sponsored retirement plans. If the employer offers a retirement plan, employees should seriously consider participating in it, as it is one of the easiest
and most beneficial means of helping to save for retirement. It is also one of the best ways to defer paying taxes on the investments.

Many working people have the opportunity to save toward retirement through their employment. According to the Bureau of Labor Statistics in 2000, 79% of private sector employers with 100 or more employees offered retirement plans.

Qualified 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, pretax dollars can be used to make payments to the annuity. When money is taken out, it will all be taxed.

Annuities can also be used to fund traditional and Roth IRAs under Internal Revenue Code Section 408. If an annuity is used to fund an IRA, purchaser’s must receive a disclosure statement describing the tax treatment.

The term Qualified (when applied to Annuities) refers to the tax status of the source of funds used for purchasing the annuity. These are premium dollars which have "qualified" for IRS exemption from income taxes. The whole payment received each month from a qualified annuity is taxable as income (since income taxes have not yet been paid on these funds). Qualified annuities may either come from corporate-sponsored retirement plans (such as Defined Benefit or Defined Contribution Plans), Lump Sum distributions from such retirement plans, or from such individual retirement arrangements as IRAs, SEPs, and Section 403(b) tax-sheltered annuities, or Section 1035 annuity or life insurance exchanges.

The qualified plan market is complex. Because qualified plans are funded with contributions that use pre-tax dollars, a qualified plan must satisfy specific provisions set forth by the Internal Revenue Code. Each type of qualified plan has its own unique definitions, limitations and exceptions. The term "tax-qualified plan" can refer to a number of different types of retirement plans that qualify for special treatment under federal income tax law. The major tax breaks qualified plans provide are as follows:

- Amounts contributed to the plan are not income taxable to the individual until they are paid out of the plan.
- Earnings in the plan are not income taxable to the individual until they are paid out of the plan.
- If it is an employer-sponsored plan, contributions made by the employer are tax-deductible to the business.

A non-qualified annuity is an annuity purchased with after-tax dollars outside employer-based retirement plan and are not subject to as many government regulations. Non-qualified contracts are purchased by individuals, executives or key employees, and not for a broader group of employees. Benefits provided to employees can go beyond the limits allowed in qualified plans. Any earnings within the plan currently will be taxable to the employer, and taxable to the employee when distributed as benefits. However, the employer will be entitled to an income tax deduction at the time of distribution. Independent contractors and directors are eligible for coverage under a non-qualified retirement plan, unlike a QRP.

Non-qualified annuities are purchased with monies on which taxes have already been paid. A part of each monthly payment is considered a return of previously taxed principal and therefore excluded from taxation. The amount excluded from taxes is calculated by an Exclusion Ratio. Non-qualified annuities may be purchased by employers for situations such as deferred compensation or supplemental income programs, or by individuals investing their after-tax savings accounts or money market accounts, CD’s, proceeds from the sale of a house, business, mutual funds, other investments, or from an inheritance or proceeds from a life insurance settlement.
Contrasts Between Qualified & Non-Qualified

For tax purposes, an annuity may be qualified or non-qualified. Non-qualified annuities are funded using after-tax dollars. Qualified annuities are funded with pre-tax dollars, as part of plans like Individual Retirement Accounts (IRAs), Simplified Employee Pension Plans (SEPs), Tax-Sheltered Annuities (TSAs) or other employer-sponsored retirement plans recognized by the Internal Revenue Service.

Anyone may purchase a nonqualified annuity for any reason. A qualified annuity is purchased as part of a tax-qualified individual or employer-sponsored retirement plan, such as an IRA, a TSA or any other plan recognized by the Internal Revenue Service. Many of these qualified plans allow employees to fund their annuities through salary reductions. These contributions are made with pretax dollars, thus lowering the employees' current taxable income. The contributions then grow within the plan on a tax-deferred basis. Differences between annuities purchased to fund qualified plans and those purchased on a nonqualified basis arise from the requirements qualified plans must meet in order to qualify for and maintain their favorable tax treatment. For example, in a qualified plan there are limitations on the amount that can be contributed to the plan and deducted from an individual's income in one year. The amount of premium that can be paid to purchase an annuity on a nonqualified basis is limited only by maximums set by some insurers.

Qualified plans and 403b arrangements are required to begin making certain minimum distributions by April 1 of the year following the year in which the individual turns age 70½. Minimum distributions may be taken in the form of withdrawals based on life expectancy or annuity payments. For annuities purchased on a nonqualified basis, distributions from the contract need not begin until the owner desires, if at all.

ANNUITY TAX LEGISLATION

To market and sell annuities effectively, the agent must understand the tax aspects of these products and how they affect contract owners and their beneficiaries. Over the years, changes in the tax laws have served to encourage the use of annuities as retirement-planning vehicles and discourage their use as short-term tax-sheltered investments. Following is a brief look at the history of annuity tax legislation.

TEFRA (1982)

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) was really the first significant piece of legislation to have an impact on annuities.

- Changed taxation of non-qualified annuities from FIFO to LIFO.
- Prior to 1982, amounts received under an annuity before an annuity starting date, such as withdrawals, were first treated as a return of the policyholder's premiums.
- Since the 1982 changes, withdrawals are now taxed on an income-out-first basis.
- Loans are treated as distributions (subject to the income-out-first rule).
- Assignments or pledges of annuity contracts are treated as distributions (subject to the income-out-first rule).
- A 5% penalty tax was imposed on certain distributions from annuity contracts prior to age 59½ if withdrawals were within 10 years of the purchase date.

DEFRA (1984)

Under Deficit Reduction Act of 1984:

- The excise penalty was broadened to apply to any withdrawals prior to age 59½. (with certain limited exceptions)
- A new distribution at death rule was imposed.
- As a result, to be treated as an annuity, the contract must contain specific language requiring distributions upon death of the contract owner or annuitant.

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• This prevented continuing deferral of tax after the death of the owner/annuitant except for a husband and wife.
• Contracts issued prior to January 1, 1985 were grandfathered exempt from these changes.

TAX REFORM ACT (1986)

The Tax Reform Act of 1986 (TRA) changed the tax treatment for annuities.

• The inside buildup was taxed if the owner of the annuity was not an individual (i.e., this corporations).
• The excise penalty tax on distributions prior to age 59½ was increased from 5% to 10%.
• Transfers and gifts of annuity contracts are treated as taxable distributions to the transferor, unless the transfer is between spouses.

TAMRA (1988)

The Technical and Miscellaneous Reform Act of 1988 (TAMRA) dealt with the aggregation rule.

• All deferred annuity contracts issued by the same company to the same policyholder during any calendar year were treated as one annuity contract. This rule prevents avoidance of the income-out-first rule through the use of multiple deferred annuities.

OBRA (1990)

Under the Omnibus Budget Reconciliation Act of 1990

• The aggregation rule (multiple deferred annuity contracts) does not apply to immediate annuities.

Small Business Act (1996)

The Small Business Job Protection Act of 1996 contained a number of provisions related to qualified plans and pension simplification. It affected the taxation of qualified annuities by modifying the exclusion ratio formula used to determine plan participant basis and the nontaxable portion of qualified annuity payments.

Employers have several choices for qualified plans such as: SIMPLE, SEP, Profit Sharing, Keogh and others. Generally, the plans available to employers fall into one of these two-categories:

1. Defined benefit

Defined Benefit Plans - These plans promise to pay a guaranteed income benefit upon retirement.

2. Defined contribution

Defined Contribution Plans – Under these plans, the employer contributes funds that the employee can withdraw upon retirement. 401 (k) plans are an example of a defined contribution plan.

3. IRA (Individual retirement account)

INDIVIDUAL RETIREMENT ACCOUNTS

Individual Retirement Accounts have been around since 1974 when they were introduced as part of the Employee Retirement Income Security Act (ERISA). Individual Retirement Accounts (IRAs) provide Americans with a tax advantaged way to save for retirement. They are available to anyone who receives

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taxable compensation during the year, with some exceptions, IRAs are not part of the employer-sponsored plan marketplace.

With a traditional IRA, the owner can no longer contribute to the IRA once reaching the age of 70½. Additionally, minimum required distributions must begin at age of 70½ as well.

IRAs represent a sizable potential source of annuity business. Generally, anyone who has earned income is eligible to establish an IRA, regardless of whether he or she is able to deduct the contribution. Many individuals have opened IRAs for their regular retirement savings. In addition, many individuals are receiving large lump-sum distributions from employer-sponsored retirement plans, either as a result of a layoff or early retirement. By rolling these distributions into an IRA, individuals can continue to defer taxes on these amounts.

Some financial analysts object to funding IRAs with annuities since both IRAs and annuities provide tax-deferral on earnings. Since the IRA is tax-deferred, buying a tax-deferred product to fund it seems "redundant." Clients who fund IRAs with annuities, say these analysts, are paying for a feature they don't need.

But tax-deferral in an annuity doesn't "cost" the client anything. There's no charge for it. It's simply part of the tax code. Death benefits, safety, performance, tax-deferral, the option to purchase an income stream guaranteed to last for life-there are many good reasons to purchase annuities, inside or outside of an IRA.

Most IRAs allow people to direct how funds in their account are invested. They may be able to invest the funds in a variety of ways, including individual stocks and bonds, annuities, and mutual funds, though there are some restrictions on how IRA funds are invested, for example life insurance policies cannot be used to fund a IRA. There are two types of IRAs - traditional and Roth. There are several basic differences between a traditional IRA and a Roth IRA.

**Traditional IRA:**

The earnings on any IRA are taxed-deferred. Depending on how much money they earn, people may also be eligible to deduct their IRA contribution from their gross income for tax purposes. But, there are penalties for withdrawing money from a traditional IRA before they reach the age of 59½, and withdrawals will be taxed as ordinary income.

- Contributions might be deductible
- Earnings are not subject to income tax in the year earned
- Distributions of contributions and earnings are generally income taxable

Where traditional IRAs are concerned, the contribution may not be tax deductible if the individual is already participating in another qualified plan. The determining factor will be income.

**Exceeding IRA Contributions Can Trigger Penalties**

Excluding rollover contributions, individuals who exceed the contribution limits for traditional or Roth IRAs are liable for a non-deductible penalty tax of 6% of the over-funded amount each year until the overpayment is corrected.

Contributions to a non-qualified annuity are not deductible for income tax purposes, however, annuities still receive special tax treatment by the IRS, as described in detail in Section 72 of the Internal Revenue Code. Unlike other investments, such as certificates of deposits and mutual funds, the earnings in an annuity are not subject to ordinary income taxes until they are withdrawn.
4. Roth IRA

Roth IRA:

This type of IRA was named after former Senator William Roth of Delaware, who championed the Taxpayer Relief Act of 1997. Eligibility is determined by the amount of annual income. Participants may not deduct contributions to Roth IRA from taxable income, but growth in a Roth IRA is tax-free.

Under a Roth IRA:

- Contributions are not deductible
- Earnings are not subject to income tax in the year earned
- Distributions of contributions and earnings generally are not income taxable.

The Roth IRA has some advantage over a traditional IRA - earnings are not only tax deferred, they can be tax-free, provided the distributions are qualified.

If someone has had their Roth IRA for more than five years, they may usually withdraw earnings from their Roth IRA without paying penalties and/or taxes, if: they have reached the age of 59½, they become fully disabled, or they are using the money to buy their first home ($10,000 life-time limit). They may also withdraw funds from a Roth IRA to pay for college; however taxes will be due on that withdrawal. They will not be subject, however, to the penalty for premature withdrawal.

In some cases, contract owners may convert a traditional IRA to a Roth IRA, but they must pay income taxes on the converted amount that was not previously taxed. As with any retirement investment, they should consult a financial professional to learn all the details before making the conversion.

The owner of a Roth IRA can continue making contributions well past age 70½ (as long as they have earned income) with no requirement for distribution. A Roth IRA owner could defer distributions until death.

<table>
<thead>
<tr>
<th>Comparing a Traditional IRA to a Roth IRA</th>
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</thead>
<tbody>
<tr>
<td>Provision</td>
</tr>
<tr>
<td>Tax deductible contributions</td>
</tr>
<tr>
<td>Contributions must cease at age 70½</td>
</tr>
<tr>
<td>Minimum required distributions at age 70½</td>
</tr>
<tr>
<td>Tax-free distributions</td>
</tr>
</tbody>
</table>

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

403(B) RETIREMENT PLANS

A 403(b) plan is similar to a 401(k), but is offered to employees of public and private school systems--K through college--and non-profit, tax-exempt organizations, such as churches, libraries, etc. Also known as tax-sheltered annuities, 403(b) retirement plans provide tax-deferred savings to employees of public educational systems and select non-profit charitable organizations. They are similar to 401(k) plans since pre-tax earnings are withheld from the employee's paycheck. The employer sponsors 403(b) retirement plans but employer contributions are not required.

In 2013, participants in 403(b) plans may defer up to $17,500 in income to 403(b) plans.
403(b) contains unique loan provisions that can avoid taxation when the contract owner exercises a loan. If the contract owner adheres to strict guidelines and be paid back systematically. Failure to comply with the guidelines set forth by the IRS may force the insurer to report the loan as a distribution. If this happens, tax consequences apply.

| 6. 401(k) |

Contributing to a 401(k) is simple; the employer deducts the amount designated from the pay, before federal taxes. The amount contributed to the plan lowers their taxable income. In many companies, the employer matches all or part of the contribution.

The employee usually gets to choose how much they want to contribute within the restrictions of the particular plan; however, the employer or its plan administrator will manage the account. Many 401(k) plans also allow people to direct how the funds are invested within the choices allowed by the plan.

**401(K) RETIREMENT PLANS**

401(k) retirement plans are the most popular of all defined contribution plans available. 401(k) plans offer Americans a savings vehicle featuring a diverse cross-section of investments from which to choose, including mutual funds and variable annuities, as well as other specialized investment funds. Employees are permitted to use pre-tax earnings to make contributions to 401(k) plans. If they change jobs, the existing 401(k) plan can be rolled into a new plan. Employers commonly match employees’ contributions as an employee benefit.

The 457 plan, offered only to state and local government employees, allows employees to set aside a portion of pay for use later—generally in retirement. Participants are not taxed on that income now; pay taxes later, when withdrawing the money from the plan. A 457 plan reduces current income taxes, while helping save for retirement, and allowing earnings to accumulate tax-deferred. In 2006, participants in 401(k) plans may defer up to $17,500 in income to a 401(k) plan.

| 7. SEP (Simplified Employee Pension Plan) |

**SIMPLIFIED EMPLOYEE PENSIONS - SEP PLANS**

A SEP plan looks like a basic profit-sharing plan. Each year the employer can make tax-deductible contributions based on a percentage of an employee’s compensation into a traditional IRA set up by the employee. All employees must receive the same percentage, although no employee can receive more than $51,000 in 2013. The employer has a great deal of flexibility because each year, a new contribution level can be chosen. If times are difficult, contributions may be skipped altogether. The maximum contribution (and employer income tax deduction) to a SEP plan is the lesser of 25% of the employee’s compensation or $51,000.

**B. Annuities and retirement planning**

Annuities can be an important part of an investor's portfolio, however, retirement planning should be based on a well-rounded investment approach.

**USING FIXED ANNUITIES IN RETIREMENT PLANNING**

*Provided* fixed annuities are not liquidated during the surrender period, they provide safety of principal and guaranteed growth. Seniors more commonly purchase fixed and equity-indexed annuities than variable annuities. Seniors usually cannot afford the risks that come with equity-based investments especially since they may depend on the funds at some time in the future for their income. Municipal bonds or corporate bonds are often included as part of an individual's investment portfolio. However, in periods of rising interest rates, principal may be susceptible to loss. Annuities can be a viable alternative to bonds.

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USING VARIABLE ANNUITIES IN RETIREMENT PLANNING

For investors willing to accept market risk in exchange for greater potential returns, variable annuities may be a better choice than other equity-based investments. Today, most variable annuities feature asset allocation, a process through which an investor allocates money across different asset classes, like stocks, bonds, cash and real estate. The process reflects an investor's personal attitudes about investing by addressing a variety of factors. By changing the asset allocation mix, investors can re-act to different market trends.

Equity-based investments are subject to risk. But variable annuities containing a guaranteed monthly income benefit rider can protect against the risk of market losses.

USING EQUITY-INDEXED ANNUITIES IN RETIREMENT PLANNING

Investors who are unwilling to accept the potential risks associated with stocks, mutual funds and variable annuities, may like equity-indexed annuities with earnings that are linked to positive changes in a major market index. Unlike the variable annuity, the investor in an equity indexed annuity does not assume investment risk. Equity-indexed annuities even include a minimum guaranteed interest rate in case the index fails to perform over the long-term. There is no risk to principal provided the annuity is held until the end of the surrender period.

Equity-indexed annuities are unique because they prevent index earnings from being lost once they are credited. To understand the significance of this feature is extremely important in retirement planning. With equity-indexed annuities, once gain is credited, it cannot be lost, even if the index loses value in subsequent years. This helps retirement income keep up with inflation without the vulnerability of the principal & past earnings to loss.
VII. DISCUSS THE APPLICATION OF INCOME TAXATION OF QUALIFIED AND NON-QUALIFIED ANNUITIES INCLUDING, BUT NOT LIMITED TO, THE FOLLOWING Instances:

A. PAYMENT OF PREMIUMS

Non-qualified annuities generally offer no deduction on contributions made to individual or group contracts . . . these contracts are purchased with after-tax dollars. On the other hand, such contracts have no limit as to the amount an individual can contribute. If an individual purchased an annuity inside his non-qualified IRA or pension plan, there would be a dollar-for-dollar corresponding deduction allowed for the premiums up to the current limit allowed . . . these contracts are bought with before-tax dollars. Premiums for annuities purchased inside a qualified plan can make a significant difference over time.

Premiums

From an income tax standpoint, the main difference between purchasing an annuity inside or outside of a qualified plan concerns the deductibility of the premium. Contributions to a qualified plan, including premiums paid for an annuity funding a qualified plan, are generally deductible from current income. Premiums paid on annuities purchased on a nonqualifed basis are not tax-deductible. Qualified plan annuities can be purchased with before-tax dollars, while nonqualified plan annuities are purchased with after-tax dollars.

<table>
<thead>
<tr>
<th>Tax-Deductible Limits of Qualified Plans, 2013</th>
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<tbody>
<tr>
<td>Individual Retirement Account (IRA)</td>
</tr>
<tr>
<td>$5,500 below age 50</td>
</tr>
<tr>
<td>$6,500 age 50 and over</td>
</tr>
<tr>
<td>Roth IRA</td>
</tr>
<tr>
<td>Not Deductible</td>
</tr>
<tr>
<td>401(k)</td>
</tr>
<tr>
<td>$17,500</td>
</tr>
<tr>
<td>403(b)</td>
</tr>
<tr>
<td>$17,500</td>
</tr>
<tr>
<td>SEP</td>
</tr>
<tr>
<td>25% of compensation up to $51,000</td>
</tr>
</tbody>
</table>

If contributions to qualified plans exceed the allowable limits, the IRS will assess a penalty each year until corrected. For this reason, agents selling qualified annuities must carefully ascertain that contributions are within the guidelines of the particular plan.

B. CASH VALUE ACCRUAL (SECTION 10168.2 OF THE CIC)

CASH VALUE ACCRUAL CIC.10168.2

An investment in an annuity, non-qualified or not, means that money will grow and compound tax-deferred, not tax free. In other words, the income tax liability is postponed. The owner may be a natural or non-natural person. Some examples of non-natural persons are corporations, partnerships, and trusts. Generally, annuity contracts owned by non-natural persons are not treated as annuity contracts for federal income tax purposes and the earnings on such contracts are taxed annually as ordinary income received or accrued by the owner during the taxable year.

California, like many states, has passed minimum nonforfeiture laws. The purpose of such laws is to make sure that contract owners receive something when and if he stops making premiums. Most annuity contracts provide cash surrender values benefits prior to maturity.

California law states that in no event shall any cash value surrender benefit be less than the minimum nonforfeiture amount at that time. And, the death benefit under such contracts shall be at least equal to the cash surrender benefit.
TAX TREATMENT OF CASH VALUES (Section 10168.2 of the CIC)

Annuities can be used to fund qualified plans, but even annuities purchased outside of a qualified plan provide income tax deferral on earnings until they are withdrawn.

Qualified annuities are similar to non-qualified annuities where income tax on the earnings is concerned. For example, qualified annuities also defer taxation on contributions and earnings until they are distributed. The IRS treats some aspects of qualified annuities differently. Tax free build-up within the contract is allowed only to “natural persons.” If an annuity contract is held by a corporation or trust, then the income on the contract is treated as ordinary income received or accrued by the owner during that taxable year.

A trust acting as the agent for a natural person would be considered a natural person. But if an employer is the agent for its employees, the employer will be taxed on the inside build up. This means annuities are no longer appropriate tax advantaged investments for nonqualified deferred compensation agreements. Exceptions from the “natural persons” rules allow tax-free build up of the following annuities:

- Annuities received by the executor of a decedent at the decedent’s death,
- Annuities held by a qualified retirement plan or IRA,
- Annuities considered “qualifying funding assets” (used to provide funding for structured settlements and by property and casualty insurance companies to fund periodic payments for damages due to injuries suffered by a person),
- Annuities purchased by an employer on termination of a qualified plan and held until all amounts under the plan are distributed to the employee or his beneficiary,
- Annuities which are “immediate,” i.e., those which have a starting date no more than one year from the date the annuity was purchased and provide for a series of substantially equal periodic payments to be made at least annually over the annuity period.

Since annuities were given their unique tax treatment to encourage long-term savings for retirement, changes to the tax code through the years discourage their use as short-term tax-sheltered investments.

C. PARTIAL WITHDRAWALS

Withdrawals from non-qualified or qualified annuities may be subject to ordinary income tax as well as penalties. Annuitization of the contract would be one way to soften the blow. Other options include systematic withdrawals, loans and full or partial surrenders, all of which can be utilized before an annuity’s maturity date. However, current tax laws are such that any of these distribution options may create a taxable event.

For annuities purchased before August 14, 1982, the general rule regarding cash withdrawals, amounts received as loans or amounts received on surrenders is that they are tax free until they equal the contract owner’s basis or investment in the contract. After that, they are fully taxable as income. These annuities are given “first-in, first-out” (FIFO) treatment.

Annuities purchased on or after August 14, 1982, the general rule regarding these same kinds of distributions is that they will be treated first as fully taxable interest payments and only second as a recovery of non-taxable basis. These annuities are given “last-in, first-out” (LIFO) treatment.

In addition, there could be IRS penalties on any annuity withdrawal. To promote the use of annuities as retirement plans and to discourage their use as short-term tax-sheltered investments, a 10% penalty is imposed on “premature” distributions, or those taken before the contract owner’s age 59½. Therefore, an individual who, at age 54, withdraws a sum of $5,000 from his or her annuity will have to pay a current tax plus a $500 penalty as well, to the extent the withdrawal is attributed to interest earnings. No penalty is imposed for distributions taken:

- After age 59½;
• In the event of disability;
• In the event of death; or as part of a series of substantially equal payments taken over life expectancy

One strategy by which annuities are sold is to buy while their tax bracket is high and withdraw when you after age 59.5 and hopefully their bracket is much lower. Therefore, the income earned will be taxed at a lower rate without penalties.

Withdrawals can be made from a non-qualified annuity. At the time of the withdrawal, the value of an annuity will be the amount paid in along with an amount that is the earnings and growth developed since the purchase of the annuity. For annuity premiums paid in after August 13, 1982, the “last in, first out” LIFO or “interest first” method of growth first withdrawals applies. The first money to be withdrawn will be the growth that is taxable. When the full amount of the growth is withdrawn and taxed in the year received, then the premium amount is available to be withdrawn with no tax on it as it was not tax deductible when deposited as “after tax” money.

Money withdrawn from a non-qualified annuity that was paid in prior to August 14, 1982 has a more tax-preferred method of withdrawal than money paid into an annuity after August 13, 1982. In these, the first amounts to be withdrawn are the premiums paid in.

These are tax-free up to the total amount paid in. Then amounts withdrawn beyond this “paid in” amount are subject to current income tax in the year withdrawn. This is referred to as FIFO, “first in, first out” or “cost recovery” method.

In qualified annuities, all withdrawals are subject to current income taxation as none of the money has been taxed previously, both premiums and growth.

Prior to age 59½, both qualified and non-qualified annuity withdrawals are subject to a 10% penalty by the IRS. In non-qualified annuities this penalty is applied to the growth portion that is withdrawn in any year. The entire amount of any withdrawals from the qualified annuity are subject to this 10% penalty if taken before age 59½.

INCOME TAXATION ON WITHDRAWALS

The funds in a deferred annuity contract accumulate free of income taxation until one of the following occurs:

• a loan, collateralization, or withdrawal from the contract;
• an annuitization of the contract; or
• the death of the contract owner.

Partial withdrawals or loans from an annuity contract during the deferral or accumulation period are subject to different income tax rules than actual annuitized payments. Withdrawals and loans are treated as taxable events for income tax purposes. No exclusion ratio applies.

If any portion of a deferred annuity’s value is attributable to earnings, a withdrawal will be considered to come from those earnings before it is considered to come from premiums paid into the contract. Deferred annuity earnings are income-taxable when paid out of the contract, while amounts representing premiums for non-qualified plans are not income-taxable when paid out of the contract.

A withdrawal is any amount distributed from the annuity that is not part of the annuitization process. Those payments are taxed based on when the annuity was purchased. If a taxpayer owns a contract that was funded on or before August 13, 1982, ”FIFO” (“first-in, first-out”) rather than LIFO taxation will apply to a withdrawal from the contract. This means that the taxpayer will be able to treat the distribution as a nontaxable return of capital until the taxpayer’s investment in the contract has been fully recovered. Investments made after August 13, 1982, are taxed on a last-in, first-out basis. That means for income
tax purposes the first money out of the annuity will be considered as earnings, not principal, and will be
taxed as ordinary income when withdrawn from the contract. The interest-out-first rule for withdrawals, is
in contrast to taxation of annuitization payments, where a portion of those payments is excludable from
income taxation. The purpose of the favorable tax treatment of annuity payments is to encourage the use
of annuities as long-term savings vehicles. In contrast, the purpose of the interest-out-first rule for
withdrawals is to discourage the use of annuities for short-term savings.

All withdrawals from qualified annuities are subject to income tax, unless the withdrawal represents some
return of cost basis. Roth IRAs are treated differently than most qualified plans in this area. Under Roth
IRAs, ordering rules apply to distributions.

**Contributions are withdrawn first** and are not subject to income tax or the 10% penalty tax.

**Conversions from traditional IRAs are withdrawn second** and are not subject to income tax or the
10% penalty tax provided they have remained in the account for at least 5 years.

**Earnings are withdrawn last** and are treated as follows:

- If the distribution meets the following rules, the earnings are **tax-free**:
  - The Roth IRA has been in force for at least 5 years; AND
  - The owner is older than 59½; OR
  - The owner makes a first-time home purchase; OR
  - The owner dies or becomes disabled.
- If the **distribution does not meet those rules**, earnings are **subject to income tax**.
  - Also, if the owner is younger than 59½, the 10% penalty tax applies.

Contract owners have a number of ways to access the values in their annuities other than through
annuitization. These options include systematic withdrawals, loans and full or partial surrenders, all of
which can be used before an annuity's maturity date. However, current tax laws are such that any of
these distribution options may create a taxable event.

**Annuities Purchased Before August 14, 1982**

For an annuity purchased **before August 14, 1982**, the general rule regarding cash withdrawals,
amounts received as loans or amounts received on surrenders is that they are tax free until they equal
the contract owner's basis or investment in the contract. After that, they are fully taxable as income. Such
annuities are given **first-in, first-out** treatment.

**Annuities Purchased After August 14, 1982**

For an annuity purchased on or **after August 14, 1982**, the general rule regarding these same kinds of
distributions is that they are treated first as fully taxable interest payments and only second as a recovery
of nontaxable basis. Such annuities are given **last-in, first-out** treatment.

**SYSTEMATIC WITHDRAWALS**

Individuals may withdraw money from their deferred annuities on a regular basis in order to provide
income over an extended period of time. Withdrawals that take place on a regular, ongoing basis are
often referred to as "**systematic withdrawals**." Many of today's deferred annuities are designed to give
individuals the option of using systematic withdrawal plans as an alternative to the annuitization.

Contracts allow the **annuity starting date** or **the maturity date**, to be deferred to a late age. There
are several important differences between obtaining income from a deferred annuity by way of
annuitization or through systematic withdrawals. These are the advantages and the disadvantages of
systematic withdrawal plans compared to converting premiums to an income stream through annuitization.
Disadvantages

- Systematic withdrawals do not guarantee an individual an income for life.
- Systematic withdrawals do not receive the same favorable tax treatment as annuity payments.
- Like any other withdrawal, systematic withdrawals are subject to the interest-out-first rule, meaning that the entire amount of any withdrawal is taxable as income until all amounts representing interest earnings have been taken out of the annuity.
- In addition, if the individual is under age 59½, the taxable amount of any withdrawal may be subject to the 10% penalty tax.

Advantages

In spite of the disadvantages, many individuals prefer systematic withdrawals to premium conversion because of the following advantages.

- Control of funds.
- Before annuity funds are converted to an income stream, the individual maintains a high degree of control over that money.
- Potential for higher returns.
- The ability to earn a current rate that will remain competitive with prevailing rates being offered on other financial vehicles, rather than being locked into a guaranteed return, is a feature that makes systematic withdrawals attractive to many people.
- Value to Heirs.
- The value that remains in an individual's deferred annuity at his or her death is payable to a beneficiary. If the individual died shortly after beginning to take systematic withdrawals, a large portion of the annuity's value would remain in the contract.

Free Withdrawals

The annuity free withdrawal, introduced in the late 1970s, allows a contract owner to withdraw a stipulated amount from his or her annuity without incurring any surrender charges. A typical free withdrawal provision would allow up to 10% of the annuity value to be withdrawn each year before a withdrawal charge would be applied. But there are many variations of free withdrawal provisions. Some allow only interest to be withdrawn without a charge. Others allow a percentage of premium to be withdrawn only after it has been in the contract for a certain period of time.

The 10 Percent Penalty for Premature Distributions

To promote the use of annuities as retirement plans and to discourage their use as short-term tax-sheltered investments, In almost all cases, funds taken out of an annuity before age 59½ will be subject not only to ordinary income tax but an ADDITIONAL 10% PENALTY tax as well. It may not be worthwhile to consider an annuity should clients need the money prior to 59½. Therefore, an individual who, at age 54, withdraws $5,000 from his or her annuity must pay a current tax plus a $500 penalty, to the extent the withdrawal is attributed to interest earnings. No penalty is imposed for distributions taken:

Subject to provisions of Section 72(q) of the Internal Revenue Code, there are exceptions where the tax does not apply. Exceptions to the 10% excise penalty tax:

- after age 59½;
- in the event of disability;
- in the event of death; or
- as part of a series of substantially equal payments taken over life expectancy.
A 10 percent penalty tax generally applies to amounts received from annuity contracts that

- are not received in the form of annuity payments and
- are received by a taxpayer who has not attained the age of 59½.

This 10 percent penalty tax applies only to the portion of any withdrawal, loan, or collateralization of the contract that is taxable under the rules above. It applies in addition to the regular income tax. It does not apply to the portion of the transaction that is a nontaxable return of capital.

Deferred annuity earnings attributable to premiums paid into the contract on or before August 13, 1982 are not subject to the 10% penalty tax on premature withdrawals.

**INCOME TAXATION ON CONTRACT SURRENDER**

Complete surrenders of annuity contracts are taxable to the extent that the cash value of the annuity exceeds the investment in the contract. However, in the case of a complete surrender of the contract, the taxpayer is permitted to reduce the cash value by any surrender charges in order to determine the taxable amount.

**QUALIFIED VS. NON-QUALIFIED WITHDRAWALS**

For tax purposes, the IRS generally views premature distributions or withdrawals from qualified plans the same as non-qualified plans . . . they are taxed at ordinary income rates. The exception is where the withdrawal is a systematic withdrawal plan or annuitization. Here, an exclusion ratio can be applied to allow part return of principal and part taxable income.

**D. LOANS AND ASSIGNMENTS**

Loans made from a non-qualified annuity have little tax consequence. However, in the case of qualified contracts there are several issues that could cause the amount loaned to be fully taxable:

- Accounts under $20,000 can loan out up to 80% of the account value up to a maximum of $10,000. Accounts $20,000 and over may loan out up to 50% of the value, not to exceed $50,000.
- Interest paid for tax-deferred annuity loans is not deductible.
- Assignments of annuity contracts are considered distributions for tax purposes and will be included in an owner's gross income to the extent that the cash value pledged or assigned exceeds the original investment. Amounts pledged may also be subject to the IRS 10% penalty for owners under age 59½.

Loans and/or assignments of IRAs are not allowed. Other tax sheltered annuities and annuities inside qualified retirement plans have special rules about loan availability and about the amounts that are allowed to be borrowed. Repayment requirements and schedules in order for the loan amounts to not be taxable also apply.

For non-qualified annuities, loans are generally not part of the contracts as partial and/or full withdrawals are available to access needed funds. However, where loan provisions on these exist, loans are treated similar to withdrawals in that the amount of growth that is part or all of the loan lose their tax deferred protection and are taxable in the year the loan proceeds are received.

Assignments are not generally allowed for qualified annuities. Assignments of rights to amounts or all non-qualified annuity money are subject to taxation of the growth portion of the amount of the assignment in the year that an assignment is executed.

**INCOME TAXATION ON LOANS**

The so called “interest first” (amounts received are treated first as interest income and further amounts are considered a recovery of cost) rule was imposed to discourage the use of annuity contracts as short
term investment vehicles. Under this rule, a loan is considered a cash withdrawal. With the exception of \textit{tax-sheltered annuities}, taking a loan from an annuity or even using the annuity as collateral is considered a distribution from the annuity and taxable as income. (Ref. Section 72 (e)(4)(A) of IRC) Annuities designed for purchase on a nonqualified basis generally do not contain loan provisions because loans are treated the same as withdrawals for tax purposes. The amount borrowed would be taxable as income and a 10\% penalty tax might apply. Since the tax consequences of loans and withdrawals are the same, paying interest on a loan is an unnecessary cost compared to an interest-free withdrawal. However, as a qualified plan, 403b annuities can offer loans that aren't recognized as income if certain requirements are met:

- In general, loans must be repaid within five years, although loans obtained to purchase a principal residence may have a term longer than five years.
- Loans must be amortized on a substantially level basis, and payments must be made at least quarterly.
- Loans to an individual cannot exceed the lesser of $50,000 or one-half of the present value of the individual's nonforfeitable accrued benefit (however, even if this latter amount is less than $10,000, a minimum loan of $10,000 may still be permitted).
- If the individual has taken out a loan previously, the $50,000 limit is reduced by the excess of the highest balance owed during the previous one-year period over the outstanding loan balance.

If a loan failed to meet these requirements the amount borrowed becomes a distribution taxable as income and subject to the 10\% penalty tax if the individual is under age 59\% and no exceptions apply. Policy loans on nonqualified annuities are a fairly recent development, created as an alternative to the 10 percent free withdrawals. Policy loans in nonqualified annuities differ significantly from qualified loans in that nonqualified annuity loans are taxable and, if taken before age 59\%, can result in a premature distribution penalty of 10\% as well.

Interest charged on policy loans is usually tied to independent indexes. In a typical policy loan arrangement, the insurer allows the contract owner to borrow up to 75 percent of the accumulated account value. The contract owner almost always pays a minimum interest charge.

\textbf{E. IRS (INTERNAL REVENUE SERVICE) SECTION 1035 EXCHANGES}

\textbf{IRS SECTION 1035 EXCHANGES}

\textit{Section 1035 Exchange}, as it relates to annuities, refers to a provision in the IRS tax code that allows for the direct transfer of accumulated funds in one annuity policy to another annuity contract without creating a taxable event. Normally, without the 1035 provision protecting the transfer, the growth in the original annuity would be taxable as ordinary income in the year received. In addition, if under age 59\% there would normally be an additional 10\% penalty on the growth portion. With the section 1035 protection, there is no current taxation on the growth portion of the original annuity and the 10\% penalty is also not incurred.

This allows the annuity owner to change annuities for optimum performance and suitability without the concern for the loss of the tax-deferred status of their annuity.

Agents are advised that they be completely familiar with 1035 exchanges so as not to have unnecessary loss of accumulated values through taxation that can be avoided under this section of the tax code.

Generally, the surrender of an existing non-qualified annuity contract is a taxable event since the contract owner must recognize any gain on the "old" contract as current income. However, under \textbf{IRC Section 1035} when one annuity contract is exchanged for another, the transfer will be nontaxable, provided certain requirements are met. First of all, the exchange must take place before the contract has been annuitized. As to the actual mechanics of the exchange, the IRS has indicated through Private Letter Rulings that it will apply a strict interpretation to the rules.
For a transaction to qualify as a 1035 Exchange, the "old" contract must actually be exchanged for a "new" contract. It is not sufficient for the policyholder to receive a check and apply the proceeds to the purchase of a new contract. The exchange must take place between the two insurance companies. Also, the tax code also says consumers can make a tax-free exchange from:

1) a life insurance contract to another life insurance contract or an annuity contract or

2) from one annuity contract to another annuity contract. They cannot, however, exchange an annuity contract for a life insurance contract.

Experts caution that it often does not make financial sense to exchange policies. First, some investors are exchanging policies because they are unhappy with how their contract or variable account has performed in recent years. But planners point out that many non-annuity investments also performed poorly during the same period. Second, a major drawback for exchanges is the potential for paying surrender fees. These are the penalties for canceling an annuity contract within a certain number of years after buying the annuity. A surrender fee might start around seven percent, for example, and decline to zero over seven years. Some surrender periods last ten years or more. If they exchange during that period, they could pay thousands of dollars in penalties. In addition, they'll be tied up with a fresh surrender period under the new contract.

Another factor to consider is whether it's worth the exchange just to get the new bells and whistles. Do they really need them? Are they worth the cost of the exchange, particularly if the old contract's surrender fees are high or the new annuity has higher costs due to the new bells and whistles?

In addition, clients may end up with a newer life expectancy table than they had under the old annuity, which can lower payouts should they annuitize. That's because with people living longer today, newer life expectancy tables won't pay out as much for each dollar of annuity value, versus an older policy with a table based on a shorter life expectancy.

In some exchanges, they may lose a portion of their death benefits if the value of their annuity is less than the contractually guaranteed death benefit. This is a distinct possibility for annuities whose value declined during the recent bear market. If the value is less than their original investment, some planners recommend simply cashing out and taking a tax deduction.

None of this is to say exchanges should never be made. The important point is that every situation is unique and they need to conduct a thorough analysis to determine whether it is economically worth switching. In some cases, it might be better to keep the old annuity and buy a new variable annuity with new money if it has benefits they want.

For qualified plans, an exchange or liquidation within the structure of the plans administration, i.e., a trustee-to-trustee transfer, can generally be accomplished without triggering a tax.

Section 1035 of the Internal Revenue Code provides that certain tax-deferred instruments can be exchanged for similar contracts without any tax consequences. Specifically, Section 1035 stipulates that no gain or loss shall be recognized on the exchange of:

- a contract of life insurance for another contract of life insurance or an endowment;
- a contract of life insurance for an annuity contract; or
- an annuity contract for an annuity contract.

An annuity contract CANNOT be exchanged for a life insurance contract.

To avoid taxation of any gain in the existing annuity, the individual must receive no cash in the transaction. The entire value of the existing annuity must be used to fund the new annuity, and the new annuity must be payable to the same party of the existing one. To assure that the transaction will be treated as a tax-free exchange rather than a surrender of the contract (which is a taxable event) and purchase of another, the value of the existing contract should be assigned to the company that will issue
the new contract at the time the new contract is applied for. Companies have developed forms and procedures that meet these requirements.

**Indirect rollovers** (when the participant/owner takes receipt of the funds) have other consequences as well. Distributions made from qualified retirement plans, like 403(b) annuities and 457 plans, are subject to automatic withholding tax in the amount of 20%. Internal Revenue Code considers the withholding a distribution unless it is added to the 80% received and re-allocated during the 60-day limit. Besides meeting the requirements of federal income tax law, agents should also be sure that exchanges comply with any applicable state laws and professional guidelines governing replacements. In California, such a transaction would meet the definition of replacement and would be subject to strict notification and reporting requirements. Agents also have an ethical obligation to assure that the exchange is in the best interest of the customer. An agent must evaluate all the financial and non-financial aspects of the transaction. The agent should determine how the customer stands in regard to contract expenses and surrender charges under each contract. Agents should compare each company's interest-crediting or fund management history, financial soundness, and payout options. The agent should analyze other contract features that are being gained or lost in the transaction.

While there are certainly many cases where a customer will be better off replacing one annuity with another, the intent of **Section 1035** is to eliminate adverse tax consequences on qualifying exchanges, not to promote inappropriate replacement sales.

Life agents who replace annuities (or life insurance) with annuities have certain basic responsibilities that apply to all consumers:

- The **Notice Regarding Replacement**
  - must be presented to the applicant at the time the application is taken
  - must be left with the applicant
- An original (or copy) of all printed communications used during the presentation must be left with the applicant.

New regulations also require agents to be certain that the new contract conveys a **substantial financial benefit** to any person 65 years or older who replaces an annuity when a surrender charge is involved.

Before an agent recommends a replacement, he or she first should think about how it would benefit the client, then about how the agent would justify the transaction to an examiner.

Much of the growth in sales of annuities in recent years has resulted from Section 1035 Exchanges. Even though some annuity enhancements have made newer annuities more attractive, agents must be sure that the exchange meets their client's objectives. Annuities are long-term, retirement-oriented investment vehicles, and exchanging them may not be best for the client. Insurance agents recommending the exchange of an annuity contract must tell clients important facts about the pros and cons of the exchange. Insurance agents are permitted to recommend such an exchange only if it is in the client's best interest and only after evaluating their personal and financial situation and needs, tolerance for risk, and the financial ability to pay for the proposed contract. This "suitability" obligation is required by law.

**F. Gift of an annuity**

**INCOME TAXATION ON GIFT OF ANNUITY**

If an annuity owner makes a gift of their annuity to their spouse, there is no taxable event. The growth portion of the annuity remains tax-deferred until surrendered or annuitized by the spouse receiving the gift. Normal taxation rules apply at the time of that ultimate transaction by the spouse.

If an annuity owner makes a gift of their annuity to someone other than their spouse, special taxation rules apply. Essentially, the owner who gives the gift is responsible for the tax due on the growth portion of the value of the annuity at the time of the gift.
If the annuity gifted was issued **after April 22, 1987**, the owner will have to pay the tax at the time of the gift on the growth portion of the value of the annuity at the time of the gift.

If the annuity gifted was issued **prior to April 22, 1987**, the owner will have to pay the tax based on the growth in the annuity value at the time of the gift when the recipient of the gift ultimately surrenders the policy, even if this is years later. At that time the original owner will be responsible for the tax on only the growth that was evident at the time of the gift previously. The recipient will be responsible for the tax on the growth in the annuity value since the time they received the gift.

If the recipient of the gift subsequently annuitizes their annuity, then the recipient of the gift will be responsible solely for the taxes attributed to the exclusion ratio of the taxable amount for each of the monthly annuity payments. Their cost basis for the calculation of the exclusion ratio for each monthly payment will be the cost basis of the original owner/donor.

Under certain circumstances, it may be beneficial for the owner to gift a non-qualified annuity to another natural person. Under current tax law, a person who gifts a nonqualified annuity to a natural person will pay taxes on the gain in the contract. The recipient takes a new stepped-up basis. If and when an annuity owner makes a gives his annuity to someone else (i.e. a son or daughter), the donor of the gift (person gifting the annuity) must recognize any gain on the contract at the time of the gift as current ordinary income. Because the donor usually has no cost basis in a qualified annuity contract, the entire cash value would be included in their income in the year of the gift. The rule does not apply to situations involving divorce decree gifts or to gifts made to a spouse. In addition to the income tax, the contract owner making the gift may also have made a **taxable gift** if, the accumulated value of the annuity exceeds the annual gift tax exclusion amount. If the gift is a taxable gift, the donor must file a gift tax return and pay any gift tax due. When contracts that were issued after April 22, 1987 are gifted, the owner has a taxable event at the time of the gift. The amount taxable to the donor (owner) is the cash surrender value of the contract minus the investment in the contract.

When annuity contracts that were issued on or before April 22, 1987 are gifted, the donor (owner) does not have a taxable event at the time of the gift. However, if the donee later surrenders the contract, the donor will be taxed on an amount equal to the difference between the cash surrender value and the investment in the contract as of the time of the prior gift (not as of the time of surrender). The balance of the gain upon surrender of the contract will be taxable to the donee.

**CHARITABLE GIFT ANNUITY**

A **charitable gift annuity** is an agreement by a charitable institution to pay a lifetime income to a donor in return for a gift of property. The donor gets an immediate income tax deduction for the gift of the property, but as each payment is made, the donor incurs liability for the following:

- **Capital gains** taxes on the portion of each payment representing appreciation in the value of the property at the time of the gift.
- **Income taxes** on the portion of each payment representing the excess of total payments over the property's appreciated value.
- The donor's original investment in the property is spread over the donor's average life expectancy and can be excluded from taxation until the entire amount is recovered.
- If payments cease upon the donor's death, the charitable gift annuity removes the property from the donor's estate for estate tax purposes.

**G. Sale of an annuity by the owner**

**INCOME TAXATION ON SALE OF ANNUITY BY OWNER**

A liquidation or sale of an annuity contract by the owner can generate a taxable event. When an annuity contract is fully surrendered during the accumulation phase, the owner must pay income tax on the earnings in the contract. The owner is not taxed on amounts that represent a return of contributions (such
as premiums or investment in the contract). In essence, the tax consequence is the same as discussed under partial withdrawals. An option to reduce taxes is to annuitize the contract.

If an annuity owner wishes to sell their annuity to someone else or to an entity, they may do so. The tax due for the seller to pay upon the sale is similar to the taxation rules of a normal surrender of the annuity and is due for the taxable year in which the sale occurs.

The tax would be calculated on the sale price, not the annuity value, minus the amount paid in. This is the portion of the annuity sale that would be taxable income to the seller.

The purchaser of the sold annuity, for future surrenders of their annuity would have taxation applied as a regular annuity owner. However, their cost basis in any calculation for taxation would be the purchase price they paid for the annuity, not the original cost basis of the original annuity owner, the seller.

How the IRS treats an annuity sold by an owner depends on whether the annuity has matured. If the annuity has not yet matured, the gain in the contract at the time of the sale is treated as ordinary income, subject to income tax. It is not considered as capital gains. If, however, the annuity is sold after maturity, cost basis is reduced by the aggregate amount of the payments that represent a return of investment. There are typically two types of annuities, what are known as assignable annuities or self-owned annuities (generally these assignable annuities are purchased by an individual for the benefit of a spouse or child and pay a monthly payment to the recipient for a specified period of time. These assignable annuities are quite easy to sell and do not require a judicial review.

The second type of annuity is known as a non-assignable annuity or structured settlement these types of annuities are funded by a single premium and are purchased to provide a predetermined payment stream to the payee and are typically the result of a lawsuit, injury settlement or wrongful death suit that has been settled. Selling this type of non-assignable annuity or structured settlement typically does require a judicial review. For annuities purchased on a nonqualified basis, the assignment provision acknowledges the owner's right to assign his or her rights under the contract to another person any time during the deferral period of a deferred annuity. Once annuity payments begin, the rights of the parties to the contract are established by the payout option chosen. The assignment provision also removes the company's responsibility for any assignment made. For annuities purchased to fund a qualified plan, the assignment provision states that the contract may generally not be assigned, except under certain conditions permitted by law (for example, as part of a domestic relations order issued by a court).

Annuities held under pension plans or owned as IRAs cannot be assigned or alienated, pursuant to Section 401(a)(13) of the Internal Revenue Code. Since these plans are for the benefit of employees, this protects the plan contributions from being garnished. If an owner sells or assigns a qualified annuity contract, it will be considered as a distribution, subject to income tax and the pre-59½ penalty tax (if applicable).

H. Death of an annuity owner (Section 10168.2 of the CIC)

INCOME TAXATION ON DEATH OF OWNER (Section 10168.2 of the CIC)

Non-qualified contracts: If the owner dies during the accumulation phase, the entire death benefit must be distributed within five years of the date of the owner’s death. However, 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 distribution 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 are also triggered by a change in the annuitant on an annuity contract owned by a non-natural person.
Unlike death benefits paid from life insurance policies, the beneficiary may be taxed on distributions made from an annuity after the owner’s death. Amounts paid under the five-year rule are taxed in the same manner as partial withdrawals or full surrenders, and amounts paid under an annuity option are taxed in the same manner as annuity payments at ordinary tax rates. For variable annuity contracts issued on or after 10/29/79, and for all fixed annuity contracts, there is no “step-up” in basis for income tax purposes and the beneficiary pays income tax on the earnings. However, the beneficiary is entitled to deduct a portion of estate tax paid on the annuity for income tax purposes. For variable annuity contracts issued prior to 10/21/79, there is a “step-up” in basis for income tax purposes and no income tax is payable on the earnings.

If the owner dies after the annuitization phase has begun, the remaining payments, if any, must be paid out at least as rapidly as under the annuity payout option in effect at the time of the owner’s death. If a beneficiary receives the remaining payments under the annuity payout option in effect at the owner’s death, the taxable and nontaxable portions of such payments will continue to be determined by the original exclusion ratio.

**Qualified Contracts:** The distribution of an annuity contract inside a qualified plan are the same as other qualified plan distributions. By law, anyone can be named as beneficiary of an qualified plan. Spouse beneficiaries can roll over the death proceeds of the IRA account into an IRA for themselves and thus avoid any taxation until withdrawals begin. Nonspousal beneficiaries must generally pay income tax upon receipt of the proceeds, excluding any nondeductible contributions the participant may have made. However, distributions to a nonspousal beneficiary may often be spread out over a number of years to avoid paying the tax all at once.

Recently, the IRS issued new rules that greatly simplify the calculation of required minimum distributions. Now, upon an IRA owner or plan participant's death, a designated beneficiary may base distributions on his or her life expectancy.

When an annuity owner dies in the accumulation phase of their annuity, their spouse, if the beneficiary, can receive the annuity and things remain unchanged while the beneficiary continues to hold the annuity. When the spouse, as beneficiary, surrenders or annuitizes the annuity they will have the same taxation and options that their original owner-spouse had would they still be living.

If the annuity is in the payout period when the owner-annuitant dies, the beneficiary retains the similar distribution and taxation status as the original owner-annuitant, as long as the payout time frame is equal to or less than what the original owner had.

If the annuity is in the accumulation period when the owner dies, the beneficiary can continue having the tax deferral of the growth, temporarily, as long as the payout to the beneficiary occurs within 5 years of the owner’s death.

California Insurance Code 10168.2 provides specific guidelines and regulations for protection of minimum values that must be provided for annuity owners and their beneficiaries.

The income tax treatment of an annuity upon the death of an owner (other than an entity), depends on whether death occurs prior to, or after, annuitization. If the owner dies prior to annuitization, the following settlement options and their respective income tax implications. If an annuity owner dies before the starting date of the annuity payments, the cash value of the contract must either be distributed within 5 years of death or used within one year of death to provide a life annuity or installment payments payable over a period not longer than the beneficiary’s life expectancy. However, if the surviving spouse if the beneficiary; the spouse can elect to assume the role of owner and continue the contract. In this instance, income tax implications have been delayed and the account may continue to grow tax-deferred. The 10 percent premature distribution penalty tax does not apply to required after-death distributions. When the owner dies on or after annuitization, the beneficiary pays the income tax on residual payments that the insurer may be required to make. If the beneficiary continues the income stream, income tax is spread out over the remaining benefit period. If a lump sum is chosen, the beneficiary pays income tax on the portion of gain represented in the distribution.
In traditional and Roth IRAs using annuities, owner and annuitant are the same person. In qualified plans, the plan trust is the owner and the plan participant is the annuitant. In either case, when the owner/annuitant dies, the beneficiary pays income tax on the distributions as they are received. In qualified plans, at the death of the participant (annuitant), the distribution options available to the beneficiary are determined by the required minimum distributions rules.

**If death occurred prior to receiving minimum required distributions, the beneficiary may choose either of the following:**

- Distribute the entire amount within five years after death of the owner; or
- Distribute the entire amount over the beneficiary’s life expectancy provided such option is exercised within one year of the owner’s death; or
- Spouse may assume ownership and continue the contract (if named as the designated beneficiary); or
- If no beneficiary has been designated, the distribution occurs within five years of the owner’s death.

**If death occurred after minimum required distributions began, the beneficiary may choose either of the following:**

- Distribute the remaining amount in lump sum provided such option is exercised within one year of the owner’s death; or
- Distribute the remaining amount over the beneficiary’s life expectancy provided such option is exercised within one year of the owner’s death; or
- Spouse may assume ownership and continue the contract (if named as the designated beneficiary)
- If no beneficiary has been designated, the distribution occurs over the owner’s term certain life expectancy.

In either one of these circumstances, distributions are subject to income tax in the year they are received.

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### 1. Ordinary income tax adjustment

**TAXATION TO THE BENEFICIARY AT THE OWNER’S DEATH**

For a contract in deferral, federal tax law requires that any gain in the contract be recognized and consequent taxes paid whenever the owner dies. An annuity does not receive a step-up in value at the owner’s death. This is also true in the event of multiple owners when any owner dies. Therefore, an annuity contract usually provides for payment of the death benefit to the beneficiary at the time of the owner’s death. This means that the beneficiary is responsible for income taxes on the contract’s gain. Annuity gain is ordinary income, so the taxes on that amount will be computed based on the ordinary income tax rates in effect in the year of distribution. There is no capital gains tax break on the earnings.

#### I. Death of an annuitant

**INCOME TAXATION ON DEATH OF ANNUITANT**

Since the annuitant is the measuring party in an insurance contract, his death may trigger a myriad of options. In a non-qualified contract, the effect on taxes depends on who is the annuitant? In the case where a husband is both the owner and annuitant of the contract, his death means the spouse can continue the contract and all tax deferral or receive death benefits under the distribution at death rules. When the annuitant is someone other than a spouse, the distribution at death rules are triggered.

The distribution at death rules state that the balance of any annuity contract may be paid by lump sum; over five years or over the life expectancy of the beneficiary. The tax effect of any choice can be as much...
as the gain of the contract over its investment at ordinary tax rates or an ordinary tax rate adjustment over time using the exclusion ratio discussed below.

For *non-qualified contracts*, an annuitant’s death may trigger a complete liquidation or annuitization of the contract. Here again, spouse beneficiaries can roll over the death proceeds of the IRA account into an IRA for themselves and thus avoid any taxation until withdrawals begin. Nonspousal beneficiaries must generally pay income tax upon receipt of the proceeds, excluding any nondeductible contributions the participant may have made. However, distributions to a nonspousal beneficiary may often be spread out over a number of years to avoid paying the tax all at once.

If the annuitant is also the owner of the annuity which is the most frequent situation; and this person dies during the accumulation phase, the distribution of the annuity value goes to the beneficiary and is taxable to the beneficiary under normal taxation of surrendered annuities rules. **The growth portion of the annuity value will be taxable to the beneficiary as ordinary income.**

In the case of an owner and annuitant being different people and the annuitant dies during the accumulation period, the owner can lessen the income tax consequences if the owner elects to take a lifetime and/or installment annuity payment option within 60 days of the death of the annuitant. The owner’s taxation will be that which applies to regular rules for taxation of the monthly annuity payments. Only a portion of the monthly payment installments will be taxable as ordinary income in the year received as a part of each payment is considered to be growth and the other portion considered return of premiums paid in.

If the annuitant dies **after** the annuity's start date (annuitization), the beneficiary pays the income tax on any residual payments that the insurer is required to make. One important exception occurs when the owner is a nonnatural person, such as a trust. In this situation, the annuitant's death results in exactly the same tax treatment as the owner's death. Amounts payable under a deferred annuity contract at the death of an annuitant (prior to the contract’s maturity) will be taxed as ordinary income to the beneficiary. The excess of (a) the death benefit (plus aggregate dividends and other amounts that were received tax free) over (b) total gross premiums is taxable.

Beneficiaries can elect to delay reporting of the gain in the year of the annuitant’s death if the beneficiary applies the death benefit under a life income or installment option within 60 days of the annuitant’s death. The beneficiary will then report income according to an exclusion ratio. The beneficiary’s investment in the contract will be the same as the annuitant’s investment in the contract. The expected return is based on the income the beneficiary will receive and the beneficiary’s life expectancy.

**1. Ordinary income tax adjustment**

When the owner and annuitant are different people and the contract is annuitant driven, the contract dies when the annuitant dies. When the annuitant dies **prior** to the annuity’s starting date (annuitization), the beneficiary may elect to receive a lump sum distribution or choose a settlement option. Income tax treatment depends on which option is elected.

- **Lump Sum Distribution** - Ordinary income tax is due on all gain in the year of distribution.
- **Settlement Option** - Provided this election is made within 60 days of the annuitant's death, taxable gain is spread over the settlement period. In this instance, an exclusion ratio will be calculated, providing tax-advantaged income.

**J. Annuity benefits distributions**

**ANNUITY BENEFITS DISTRIBUTIONS**

Because annuities receive favorable tax-deferred treatment, over a period of years a “**pot of money**” placed in an annuity can grow to a larger sum compared to an investment, like a CD, where the earnings are being taxed at the investor's marginal tax rate.

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For example, a $10,000 investment at 6% tax-deferred compound interest will grow to $57,435. Of course, at distribution time, there is a tax to pay. If one could find a tax-free 6% alternative (such as a tax-free municipal bond) it would grow to the same amount with no tax.

Such investments are not typical and do come with a risk of principal. The same $10,000 in a taxable CD, assuming a 28% marginal tax would grow to only $35,565.

When an annuity is ready to payout, there are several distribution options. Clients can take a lump sum, make partial withdrawals or annuitize the contract with annual payments of both principal and interest. Under non-qualified contracts, the amount of each annuity payment that won’t be taxed is computed using an exclusion ratio, which is determined by dividing the net investment in the contract by the total amount expected to be distributed during the payout period.

In qualified contracts, clients willing to take their distributions in periodic payments a similar tax break is granted. However, the IRS sets forth three methods for determining whether payments to individuals from their IRAs or from their qualified retirement plans constitute a series of substantially equal periodic payments. The three methods are:

(i) the required minimum distribution method;
(ii) the fixed amortization method; and
(iii) the fixed annuitization method.

Under the required minimum distribution method, the annual payment for each year is determined by dividing the account balance for that year by the number from the chosen life expectancy table for that year.

Under the fixed amortization method, the annual payment for each year is determined by amortizing in level amounts the account balance over a specified number of years determined by using the chosen life expectancy table and the chosen interest rate.

Under the fixed annuitization method, the annual payment for each year is determined by dividing the account balance by an annuity factor that is the present value of an annuity of $1 per year beginning at the taxpayer’s age and continuing for the life of the taxpayer (or the joint lives of the taxpayer and beneficiary). The annuity factor is derived using the mortality table.

Once an accepted method is chosen the client will be taxed on the distribution from his plan minus a prorated part of any investment in the plan (paid with after-tax dollars or contributed by an employer but taxable to the client). If he has no costs, then his entire distribution is taxed.

MINIMUM REQUIRED DISTRIBUTIONS

Under current regulations, the IRS requires all owners of qualified annuities (with the exception of Roth IRAs) to begin taking annual distributions by April 1 of the year after the owner reaches the Required Beginning Date at the age of 70½.

Minimum Required Distributions are calculated by dividing the ending account value of the previous year by a life expectancy factor. Distributions are usually calculated using the Uniform Lifetime Table which starts with a life expectancy of 27.4 years at age 70 and gradually decreases each year to 1.9 years at age 115.
Example: the annuitant is 74 years old. The value of his qualified annuity on December 31st of the previous year was $480,000. The factor from the uniform table is 23.80. The required minimum distribution for this year will be $20,168.06. Next year, the minimum required distribution will be based on the new value of his annuity and the life expectancy factor correlating to that of an individual one year older.

Owners of multiple IRAs are allowed to consolidate IRA accounts, allowing the MRD to be taken on the whole from any combination of accounts. **403(b)** annuities can also be consolidated in a similar manner. However, with other qualified plans, the MRD must be calculated and distributed from each plan separately.

1. **Discuss the exclusion ratio and its application in distribution calculations**

**ANNUITY BENEFITS DISTRIBUTIONS - “EXCLUSION RATIO” AND ITS APPLICATION**

When an annuitant receives a monthly income benefit during the payout phase of their annuity, the income taxation for them is based on an "exclusion ratio" basis and calculation. This allows for the IRS to tax a portion of each payment and for the annuitant to receive a portion of each payment tax free as a return of their investment into the annuity over time during the accumulation phase.

When the insurance company determines a monthly amount that will be paid out over the annuitant’s life to their life expectancy age, a portion of it will be taxed and a portion not taxed. The basic calculation to determine each portion looks like the following example:

The monthly annuity payment amount is multiplied by the number of months from the person’s age at the time of the first payment to their life expectancy age. This total amount is referred to as the "expected return". Then take the amount of money paid into the annuity and divide it by the total expected payments or “expected return” over the annuitant’s life expectancy previously calculated above. The resulting percentage is the percent of each monthly payment that will be non-taxable. The balance of each payment will be taxable.

**The "Exclusion Ratio" for Annuitized Payments**

The exclusion ratio for annuities purchased on a non-qualified basis arises from the idea that the payment consists of two parts: one part as-yet-untaxed earnings and one part premium upon which income taxes have already been paid. However, in a qualified plan annuity, taxes have not yet been paid on either the

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**Uniform Lifetime Table**

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premium or the earnings, so the entire payment is taxable as income. (Note: In some cases, nondeductible contributions may be made to qualified plans, and an exclusion ratio can be applied to those nondeductible contributions.) Annuited income payments are taxed according to a concept known as the exclusion ratio. Part of each payment the annuitant receives is considered to be a return of principal, which is not taxed. The remaining portion of the payment, consisting of interest earnings, is taxable to the annuitant. The exclusion ratio determines the taxable and nontaxable portions of each payment according to the following formula:

**Investment in the contract - Expected return**

The numerator of the fraction is the amount of the "investment in the contract." The denominator of the fraction is the total "expected return" under the contract. The periodic annuity payment is multiplied by this fraction to calculate the portion of the payment that is received tax free by the annuitant as a return of the investment in the contract. The balance of the payment is taxable to the annuitant. The "investment in the contract" (also is known as the annuitant's basis) is the amount the annuitant paid into the annuity in the form of premiums. The expected return is the total amount he or she will receive as income payments, based on the income option selected. The resulting ratio is the percentage of each benefit payment that is excluded from tax.

The excludable portion of any annuity payment may not exceed the unrecovered investment in the contract (unless the annuity started before January 1, 1987). (IRC Section 417(b).) The "unrecovered investment in the contract" is the policyowner’s premium cost (reduced by any dividends received in cash or used to reduce premiums and by the aggregate amount received under the contract on or after the annuity starting date to the extent it was excludable from income). This rule limits the total amount the policyowner can exclude from income to the total amount of his contribution. Once an annuitant actually lives longer than his or her actuarial life expectancy, 100 percent of each payment will be taxable. After the cost basis is fully recovered, payments received subsequently are taxable in full. If the participant dies before the cost basis is fully recovered, an income tax deduction for the unrecovered basis is allowed on the participant's final income tax return. If the annuity starting date was before November 19, 1996, different rules were applicable. Since qualified plan annuities are generally purchased with premium dollars that have not yet been income-taxed, those premiums are taxable as income when they are paid out of the contract. As a result, exclusion ratio does not apply to income payments from a qualified plan annuity.

See IRS Publication 939, *General Rule for Pensions and Annuities*, for the details on how to calculate taxes due on annuity payments.

**THE EXCLUSION RATIO CAN HELP REDUCE TAX ON SOCIAL SECURITY INCOME**

Seniors in particular can benefit from the power of an exclusion ratio. That is because too much taxable income can trigger additional taxes on Social Security benefits. If a client elected to withdraw interest from their annuity instead of annuitizing, 100% would have been reported as income, putting her Social Security benefits more at risk of being taxed.

Similarly, the exclusion ratio also helps by generating tax advantaged income during annuitization. Seniors could potentially minimize the taxation of Social Security benefits by choosing annuitization instead of using other taxable income sources.

**Taxes on Variable Annuity Payouts**

Annuity payments made as an annuity under a variable annuity are not subject to the same exclusion ratio as is a regular fixed annuity. This is because it is impossible to determine the expected return. Instead, the following formula is used:

\[
\text{INVESTMENT IN CONTRACT} \div \text{NUMBER OF YEARS OF EXPECTED RETURN}
\]
2. **Tax-deferred compounding**

The first thing that comes to mind when discussing deferred annuities is the fact that the income earned on the funds within the contract is not subject to current taxation. Only when funds are withdrawn are the earnings taxed. This greatly enhances the product's ability to build assets for the long term. In exchange for tax deferral, the annuity must be used as a long-term product whose values are reserved for retirement. If funds are accessed earlier, they may be subject to a tax penalty.

**Tax-deferred** means postponing taxes on interest earnings until a future point in time. In the meantime contract owners earn interest on the money they're not paying in taxes. Clients can accumulate more money over a shorter period of time, which ultimately will provide a greater income.

Because taxes are not paid on earnings every year, an annuity is able to work harder thanks to tax-deferral. Taxes will eventually have to be paid on earnings when the annuity's gains are withdrawn.

![Graph showing tax-deferred vs. taxable earnings over years](image)

NO taxes are paid while the money is compounding. A lower tax is also paid on random withdrawals because clients control the tax year in which the withdrawals are made, and only pay taxes on the interest withdrawn. Tax deferral provides control over an important expense -- taxes. The longer this particular expense can be postponed, the greater the gain when compared to the gain on a fully taxable account.

To illustrate the increased earnings capacity of tax-deferred interest, compare it to fully-taxable earnings.

$25,000 at 6.0% will earn $1,500 of interest in a year. A 28% tax bracket means that approximately $420 of those earnings will be lost in taxes, leaving only $1,080 to compound the next year. If these same earnings were tax-deferred, the full $1,500 would be available to earn even more interest. The longer taxes can be postponed, the greater the gain.

**Tax-Deferred vs. Fully Taxable**

*Compare the Return*

$107,297 Accumulated in a Tax-Deferred Annuity
$71,966 Accumulated in a Taxable Account

*The Difference: $35,331*

In general, tax-deferral on earnings does not extend to annuities owned by "nonnatural persons," such as corporations, although there are some exceptions. Only the following nonnatural persons can obtain the benefit of tax-deferral on deferred annuities:

- Estates of deceased individuals
- Qualified pension, profit-sharing, stock-bonus, 403b, or Individual Retirement Account (IRA) plans
- Trusts established for the benefit of a natural person
- Premiums paid for annuities before February 28, 1986.

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a. Discuss the proper way to compute taxable vs. tax-deferred vs. tax-free returns

**UNDERSTANDING TAXABLE VS. TAX DEFERRED VS. TAX-FREE**

Returns on investments may be **taxable, tax-deferred, or tax-free**. It is important for agents to be able to explain the difference between these and especially to be able to assist clients in determining which investment provides the best return after taxes.

- **Taxable** investments, such as CDs and money market accounts, earn interest that is taxed each year, whether or not the insured withdraws funds.
- **Tax-deferred** investments, like annuities, earn interest that is not taxed until withdrawn.
- **Tax-free** investments, like municipal bonds, earn interest that is not subject to income tax at all.

Agents and consumers need to understand that choosing the annuity with highest rate doesn’t always result in the highest return. Since tax-advantaged investments tend to have lower pre-tax yields than taxable investments, it is important to convert a taxable yield into an after-tax yield so that consumers will be able to compare products and make an informed decision.

b. Discuss the long term effect of tax-deferred compounding vs. other available investment choices

**Long Term Effect of Tax-Deferred Compounding vs. Other Available Investment Choices**

**CALCULATING THE TAX EQUIVALENT YIELD**

Converting tax-advantaged yields to taxable equivalent yield is really very simple. Knowing the rate of return on a currently taxable investment, the following formula will allow them to determine the rate of return on an after-tax basis:

\[
\text{Before-tax return} \times (1 - \text{Tax bracket}) = \text{After-tax return}
\]

**Income distributions**

Often an individual does not want to commit to a lifetime payout option. He or she may wish only to take income for a period of time, then reevaluate his or her economic situation and risk tolerance as well as economic conditions in general.

**K. Tax effect on beneficiary estate issues**

**TAX EFFECT ON BENEFICIARY ESTATE ISSUES**

In the event of the death of an annuity owner/annuitant with an annuity in the accumulation phase, the value of the annuity at the time of death is includable in the gross estate of the annuitant/owner for calculation of any estate taxes due, if any.

In the above scenario, if the annuity is in the payout phase, the sum of the balance of payments which are still due, if any, to survivors under various annuity settlements with survivor benefits will be included in the gross estate of the deceased owner/annuitant.

If the annuity settlement option was a life only payment option in the above examples, then the payments cease at the owner/annuitants death and, therefore, no value will be included in the deceased person’s estate.

If an owner and annuitant are different persons and the owner dies, the entire amount of the annuity value will be included in the owner’s estate upon death.
The Income Tax Bracket of Beneficiaries

A beneficiary pays ordinary income tax on annuity gains. If the beneficiary is a high-income earner, gains (and pre-tax contributions) are taxed at the beneficiary's income tax rate. If wealth transfer is the sole objective in purchasing an annuity, life insurance is more suitable.

L. Disclaimer - Attachment II (Section 789 of the CIC)

Disclaimer

The obligation agents have in California to notify all customers for annuities and life insurance sales or transactions that there may be tax consequences coinciding with these products given the varying transactions that can occur over one's lifetime.

The “Attachment III” (AB 2107, Scott, Chapter 442, Statutes of 2001) at the end of the course speaks to these and many other areas of required disclosure to each and every client and purchaser of products that you sell to them or advice you give them on current products that they have or own. If a life agent offers to sell to a client any life insurance or annuity product, the life agent must advise the client or the client’s agent, in writing, that the sale or liquidation of these products may have tax consequences. Please read this amendment fully at this time.

Agents must also disclose that their client may wish to consult independent legal counsel or financial advice before buying, selling or liquidating any assets being solicited or offered for sale.

Section 789 of the CIC provides for authority to prosecute agents and levy penalties for infractions in full and specific disclosures to consumers of annuities and life insurance.

THE TAX STATUS OF ANNUITIES (CIC Section 789.8)

"If a life agents offers to sell to an elder (65 years of age or older) any life insurance of 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... and that the elder or elder's agent may wish to consult independent legal or financial advice."

Under current federal law, annuities receive special tax treatment. Income tax on annuities is deferred, which means they aren't taxed on the interest their money earns while it stays in the annuity. Tax-deferred accumulation isn't the same as tax-free accumulation. An advantage of tax deferral is that client’s tax bracket may be lower when they receive annuity income payments than during the accumulation period. They will also be earning interest on the amount that would have been paid in taxes during the accumulation period. Most states' tax laws on annuities follow the federal law. The taxation of the actual annuity payments under the contract is subject to specific tax rules. In addition, such payments are typically deferred for some period of time after the inception of the contract, either until the annuitant reaches a specified age or for some period thereafter at the discretion of the contract owner. During this period of "deferral," the funds in the contract are generally permitted to accumulate on a tax-deferred basis. However, if a withdrawal, loan, or other financial transaction involving the contract is done before the commencement of the stream of annuitized payments, additional tax rules apply to the transaction.

DISCLAIMERS (CIC 789, AB 2107)

New legislation requires California agents to uphold a duty of honesty and fair dealing and establishes special handling where seniors and Medi-Cal eligibility is concerned. There are specific disclosures agents must provide clients, some of which are discussed in Attachment III at the back of this course. In particular, AB 2107 strengthens the Elder Abuse and Dependent Civil Protection Act with respect to selling insurance and financial products to elders by defining what is abuse and outlining required disclosures needed when suggesting a financial product geared to Medi-Cal eligibility. Others involve a responsibility to apprise clients on the following issues:
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 a professional.

There are severe and long-range penalties and consequences for violating these disclaimers. Most are included in the Section 789 of the California Insurance Code.
VIII. A. ADVANTAGES AND DISADVANTAGES 8%

ADVANTAGES & DISADVANTAGES OF ANNUITIES

Beyond tax advantages, there are important reasons to invest in an annuity, especially compared to the limitations of other types of investments. For example, annuities can provide:

- **No risk of loss** ("fixed" annuity), unlike other forms of stock or fund investments, annuities include minimum guarantees to limit the amount of investment risk.
- No-penalty rollovers.
- Company pension or profit-sharing plan payouts may be reinvested without incurring current taxes or penalties.
- No probate in case of death, as long as beneficiaries are specified by the contract owner.
- Shelter investment earnings.
- Retired people can use annuities to shelter investment earnings that would otherwise lead to taxation of their Social Security benefits.

1. Advantages of annuities

THE ADVANTAGES

Protects and builds a person’s cash reserve. The insurer guarantees principal, interest, and the promise (if purchased) that the annuity can never be outlived. This makes the annuity particularly attractive to those who have retired and desire or require fixed monthly income and lifetime guaranteed.

TAX-DEFERRAL

Because the interest on an annuity is tax-deferred, an annuity paying the same rate of interest (after expenses) as a taxable investment will result in a higher effective yield.

Fixed, equity-indexed and variable annuities all receive special tax treatment by the IRS, allowing earnings to be deferred until withdrawn. This is a benefit for all age groups, young and old. For people under the age of 60 a flexible premium deferred annuity provides a systematic way to supplement employer sponsored retirement plans where cash values accrue quicker due to tax referral. This could mean even greater tax savings if the client’s tax rate decreases at retirement. For people 60 years and older an advantage is that annuity earnings aren't subject to income tax until withdrawn. Some investments - like CDs, mutual funds and corporate bonds - are taxed regardless if the earnings are withdrawn.

A client can “time” the receipt of income and shift it into lower bracket years. This ability to decide when to be taxed allows the annuitant to compound the advantage of deferral.

ANNUITIZATION

The guarantees of safety, interest rates, and lifelong income give the purchaser peace of mind and psychological security.

All annuities, whether deferred or immediate, can provide a variety of income streams. Life settlement options offer income that cannot be outlived, something no other investment can offer. And if the funds are non-qualified, when annuitized, because of the exclusion ratio, the income stream is tax advantaged as well. For younger people, annuitization can provide an income stream with the income tax on gains spread over the term of the settlement option.

For older people, non-qualified settlement options may help reduce the taxation of Social Security benefits by reducing the amount of income subject to taxation.

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LIQUIDITY

Today most annuities allow withdrawal of up to 10% of the account value yearly without incurring a surrender charge. Also, crisis waivers may allow a complete withdrawal without surrender charges under specific circumstances. Because a 10% penalty tax applies when funds are withdrawn prior to age 59½, the liquidity advantage for younger people is much less advantageous than for those older than 59½.

- Earnings can be withdrawn instead of annuitizing, however, earnings are taxed when withdrawn.
- Access to at least a portion of funds provides a feeling of security when unforeseen financial needs arise.

PROBATE AVOIDANCE

Although usually associated with people over 60, this advantage can apply to younger people as well. When a beneficiary has been named on the contract death benefits in an annuity do not become part of the probate estate. This allows the family access to the funds sooner and without costs of probate.

Advantages:

- **Safety** of principle and earnings
- **Flexibility** through 1035 exchanges and ability to transfer funds from one subaccount to another in variable annuities.
- **Deferred Taxation** with the ability to choose when the funds will be taxed and even to spread it out over more than one generation through a stretch annuity.
- **Professional Asset Management** so investors don’t have to worry about day-to-day fluctuations in the market.
- **Enhanced Wealth Benefit** to take care of estate taxes or other estate needs.

### a. For persons under 60 years old

FOR PERSONS UNDER 60 YEARS OLD

- Tax-Deferral
- Flexibility
- Spousal takeover at owner’s death
- Liquidity
- Probate avoidance
- Professional Asset Management
- Guaranteed Death Benefit

### b. For persons 60 years and older

FOR PERSONS 60 YEARS AND OLDER

- Tax-Deferral
- Annuitzation
- Liquidity
- Probate avoidance
- Lifetime income
- Guaranteed Death Benefit
- Enhanced Death Benefit
- Safety
- Professional Asset Management

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### c. Surrender charges

**SURRENDER CHARGES**

Surrender charges allow current owners and prospective purchasers to know exactly what the cost of surrender will be. With most other investments, the owner has no way of knowing in advance what the charge for surrender is going to be. Another advantage of surrender charges is that it protects the insurance company from adverse selection in the event economic conditions might cause many policyholders to withdraw their annuities at the same times which could be catastrophic for insurers. Surrender charges protect insurers which also protects contract owners so that their funds are safe.

### 2. Disadvantages of annuities

**THE DISADVANTAGES**

A long-term cash flow stream of a fixed amount may not keep pace with inflation. With a few limited exceptions, an annuity contract held by a corporation or other entity that is not a natural person is not treated as an annuity contract for federal income tax purposes. This means that income on the contract each year is treated as current taxable ordinary income to the owner regardless of whether or not withdrawals are made.

**PRE-59½ DISTRIBUTION PENALTY**

Annuities are designed to be long-term savings vehicles. With few exceptions, a deferred annuity has a penalty tax of 10% when funds are withdrawn prior to 59½. The penalty tax was created to discourage the use of annuities as short-term tax-sheltered investments. Using annuities for younger people may not be suitable. There are a few exceptions where the penalty tax does not apply. A 10 percent penalty tax is generally imposed on withdrawals of accumulated interest prior to age 59½ or disability. The 10% penalty tax does not apply for people over 59½ years old so it is not an issue for those over 60.

**ANNUITIZATION**

When a sum of money is annuitized, it is exchanged for an income stream. When a settlement option is selected:

- The policyholder relinquishes control of the deposit
- Once the payout starts, it cannot be stopped or changed to a different settlement option.
- A settlement option can't respond to future need for additional income or access to the principal.

**TAX TREATMENT OF GAINS**

Receipt of a lump sum at retirement could result in a significant tax burden. Annuity gains are taxed as ordinary income when they are distributed. If a settlement option is elected, gains are generally spread over the duration of the settlement option. Annuity gains are not treated as capital gains. Under current tax laws, the top ordinary income tax rate is 35% while the top capital gains rate is 15%. For younger people, this is not a significant an issue because the pre-59½ penalty tax is designed to discourage access for younger people anyway while an annuity is in a state of tax deferral. However, older people in high tax brackets should compare annuities with other income options that may be available.
a. For persons under 60 years old

FOR PERSONS UNDER 60 YEARS OLD

- Pre 59½ Distribution Penalty
- Non-material person ownership – no tax deferral
- Insurance company fees & expenses
- Loss of control of principal

b. For persons 60 years and older

FOR PERSONS 60 YEARS AND OLDER

- Ordinary Income Tax Treatment
- No step up in value
- May not keep up with inflation
- Loss of control of principal
- Insurance company fees & expenses

c. Surrender charges

SURRENDER CHARGES

Charges could prove expensive to compensate the insurer for the sales charges and other expenses. If annuities are liquidated prior to their term, surrender charges usually apply. Some annuity contracts have excessively high surrender charges. For older people who may need access sooner than younger people, surrender charges can be a huge disadvantage. Some products have surrender charges that last many years. Annuity contracts are available with surrender charges as short as three years. Agents should take the time to understand the client's needs prior to recommending an annuity. Selling an annuity with a surrender schedule that exceeds the client's need for the funds is unsuitable.

3. Illustrate/show the advantages and disadvantages of the following types of investment alternatives to annuities that include CD's, money markets, savings, mutual funds, stocks, bonds, commodities, options, limited partnerships, promissory notes, real estate investment trusts, and viatical settlements

HOW ANNUITIES COMPARE TO OTHER INVESTMENTS

CERTIFICATE OF DEPOSIT

Like annuities, CDs are not tax free; the principal is protected and free of market risk; a charge applies to early withdrawals; and there is limited liquidity. Unlike annuities, CDs are not tax deferred; there is no 10% tax penalty for pre 59½ distributions, there is no provision for tax-advantaged lifetime income; the CD does not avoid probate and it cannot help reduce the taxation of social security.

MONEY MARKETS

Like annuities, money market accounts are free from market risk and principal risk and neither investment is tax free. Unlike annuities, however, there is no tax penalty for early distribution nor is there a fee; money market accounts have more liquidity than annuities but do not offer any provision for tax-advantaged lifetime income or avoid probate or help reduce tax on social security benefits.
**MUTUAL FUNDS**

Neither annuities or mutual funds are tax-free investments. Unlike annuities, mutual funds are not tax deferred, they do not provide protection from either market or principal risk; there is no fee for early withdrawal nor is there a tax penalty for pre 59½ distributions; mutual funds do provide more liquidity but they do not provide tax-advantaged lifetime income, avoid probate, or help to reduce taxation of social security benefits.

**STOCKS**

Neither stocks or annuities are tax-free.

Unlike annuities, stocks are not tax deferred; stocks are subject to both market risk and principal risk; stocks allow more liquidity than annuities; there is no fee for early withdrawals nor is there any tax penalty; stocks do not avoid probate nor do they help reduce tax on social security benefits.

**BONDS**

Bonds have about the same amount of liquidity as annuities. Unlike annuities, bonds are not free from market risk and, with the exception of government bonds, they are also subject to principal risk. Most bonds do not contain a charge for early withdrawal and are not subject to the 10% tax penalty for pre age 59½ withdrawal either. Bonds do not provide a tax-advantaged lifetime income nor do they avoid probate or help reduce taxation on social security benefits.

**COMMODITIES**

Neither annuities or commodities are tax-free investments. Both allow access to investments, however the commodities do not charge a fee for access nor a tax penalty for early withdrawal. Unlike annuities, commodities do not provide a tax-advantaged lifetime income nor do they avoid probate or help reduce taxation of social security benefits.

**OPTIONS**

Both options and annuities allow access to funds and neither is a tax free investment. Unlike annuities, options are not tax-deferred; they are subject to both market risk and principal risk; options may charge a fee for early withdrawals but are not subject to the 10% tax penalty for pre age 59½ withdrawals. Options don’t provide a tax advantaged lifetime income nor do they avoid probate or help to reduce tax on social security benefits.

**LIMITED PARTNERSHIPS**

Neither limited partnerships nor annuities are tax-free investments. Unlike annuities, limited partnerships are not tax deferred. Principal is free from market risk however they don’t provide safety of principal. There is no access to the account value therefore there is no penalty tax on pre 59% withdrawals. There is no provision for tax-advantaged, lifetime income, they don’t avoid probate nor do they reduce taxation of social security benefits.

**PROMISSORY NOTES**

Like annuities, promissory notes provide safety of principal. Neither promissory notes nor annuities are tax-free investments. Unlike annuities, promissory notes are not tax deferred. Principal is not free from market risk. No access to the account value therefore there is no penalty tax on pre age 59½ distributions. Promissory Notes do not provide tax-advantaged lifetime income; do not avoid probate and do not reduce taxation of social security benefits.
**REAL ESTATE INVESTMENT TRUSTS (REIT)**

Like annuities, there is access to the account value. Neither Real Estate Investment Trusts nor annuities are tax free. Unlike annuities, Real Estate Investment trusts are not tax deferred; principal is not free from market risk. REITs do not provide safety of principal nor do they charge for early withdrawal. There is no 10% penalty for pre age 59½ distributions. REITs do not provide tax-advantaged lifetime income; do not avoid probate nor do they reduce taxation of social security benefits.

**VIATICAL SETTLEMENTS**

Like annuities, viatical settlements are free from market risk. Neither viatical settlements nor annuities are tax free. Unlike annuities, viatical settlements are not tax deferred; do not provide safety of principal; do not allow access to the account value nor do they apply a penalty for pre age 59½ distributions, there is no tax-advantaged lifetime income. Viatical Settlements don’t avoid probate nor do they reduce taxation of social security benefits.

**SAVINGS**

Like annuities, savings are free from market risk and principal risk and neither investment is tax free. Unlike annuities, however, there is no tax penalty for early distribution nor is there a fee; savings accounts have more liquidity than annuities but do not offer any provision for tax-advantaged lifetime income or avoid probate or help reduce tax on social security benefits.
IX. INTRODUCE SALES PRACTICES FOR CALIFORNIA INSURANCE AGENTS-15%

SALES PRACTICES FOR CALIFORNIA INSURANCE AGENTS

The selling of insurance and annuities is complex. There are still many unknown factors about premiums or benefits; the clientele are typically old and forgetful and the proof that the agent did a good or bad job may not surface for 20 or 30 years; all of which promote the possibility that a lawsuit could land in your lap at anytime, up through your own retirement. That is why agents must practice due care at every moment and through every phase of the annuity sale.

A few ways to minimize conflicts between the agent, clients and the insurance carrier include:

- Select product that is suitable for each client.
- Know the product they are selling, including all reasonably priced and widely available options the policy offers.
- Be sure coverage is adequate at the time of sale.
- Be wary of "special agent relationships" that may define agents as a fiduciary to the client.
- Avoid dual agency status where agents have defined themselves as an "expert" or having special knowledge.
- Develop standard operating procedures to handle all clients the same.

Consult an attorney or capable advisor before giving clients advice in areas of taxation, estate planning, asset protection, financial planning, etc.

For the benefit of all annuity purchasers in California, especially seniors over 65 years old, there are obligations and rights that agents must be aware of and adhere to in their performance of quality salesmanship and financial counseling with their clients.

Seniors have an added measure of need for legislated protection since their situations have special characteristics with generally fixed incomes and the need for all their financial affairs and products purchased to be appropriate and suitable for their situation.

Federal and state benefit programs like Medi-Cal, Medicare, Medicare Supplements, and Social Security are all of special significance to seniors more than any other age group in California. Income and assets of seniors greatly affect their eligibility and availability of financial, medical benefits, and long term care programs.

To protect California’s seniors and others investing their hard earned money to prepare for and payout during retirement through the use of annuities, specific requirements regarding advertising, prohibited sales practices, suitability disclosure, illustrations, replacement, cancellations & free look periods, and the agent knowledge of contracts have been addressed by legislation and regulation. Specific areas of compliance in California:

NEW TRAINING REQUIREMENTS (Section 1749.8 of CIC)

If any part of an agents’ income comes from the sale of annuities. They are subject to new training requirements.

Effective January 1, 2005 every life agent selling annuities must have completed eight hours of State-specific annuity training from an approved continuing education provider. After January 1, 2005, agents are not permitted to sell annuities until the initial training requirement has been met. Thereafter, the agent must complete four hours every two years prior to license renewal.

- Only courses specifically filed and approved to meet the State’s curriculum will satisfy the new training requirements.
• This requirement applies to all agents who sell annuities, not just those who deal with seniors.
• The new training requirements apply to resident and non-resident agents alike, with the exception of direct response providers domiciled out-of-state.
• For resident agents, this requirement is considered to be part of (not in addition to) the continuing education requirements set forth by the Department Of Insurance. For agents with newly issued or renewed licenses, the new training requirements must still be met prior to January 1, 2005.

A. Required insurance producer product training (Section 10509.915(b) of the CIC)

Section 10509.915(a) CIC (2012) An insurance producer shall not solicit the sale of an annuity product unless the insurance producer has adequate knowledge of the product to recommend the annuity and the insurance producer is in compliance with the insurer’s standards for product training. Insurance producers may rely on insurer-provided product-specific training standards and materials to comply with the product-specific training requirement.

Assembly Bill (AB) 689 (Chapter 295, Statutes of 2011) Insurance Annuity Transactions became effective January 2, 2012. AB 689 adds Section 10509.915(a) to the California Insurance Code which states that an insurance producer must not solicit the sale of an annuity product unless the insurance producer has adequate knowledge of the product to recommend the annuity and the insurance producer is in compliance with the insurer’s standards for product training. Insurance producers may rely on insurer-provided product-specific training standards and materials to comply with the product-specific training requirement. Please note that AB 689 does not change the annuity training requirements which are stated in Section 1749.8 of the California Insurance Code. The annuity product-specific training is a separate requirement from the eight and four-hour annuity training noted above.

Section 10509.915(a) CIC (2012)

An insurance producer shall not solicit the sale of an annuity product unless the insurance producer has adequate knowledge of the product to recommend the annuity and the insurance producer is in compliance with the insurer’s standards for product training.

Insurance producers may rely on insurer-provided product-specific training standards and materials to comply with the product-specific training requirement.

Section 10509.915(b)(2012)

In addition to the above, an insurance producer shall complete a one-time eight credit-hour annuity training course by an approved education provider, prior to commencing the transaction of annuities. Further, every producer who engages in this state in the sale of annuity products shall satisfactorily complete a four-hour refresher annuity course prior to license renewal every two years.

B. Describe the rights and obligations of the insurance producer at contract inception

RIGHTS AND OBLIGATIONS OF THE AGENT

California agents selling annuities have certain responsibilities; some are specific to seniors while others apply to all consumers.

"All insurer, brokers, agents, and others engaged in the transaction of insurance owe a prospective insured who is 65 years of age or older, a duty of honesty, good faith, and fair dealing."

Section 785 of the California Insurance Code Many of the provisions of Senate Bill 620 (Scott, 2003) reinforce the agent’s duty of honesty, good faith and fair dealing in regard to selling annuities to seniors.

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1. Required disclosures (Section 789.8 of the CIC)

**AGENT'S RESPONSIBILITY FOR DISCLOSURES (SECTION 789.8 OF THE CIC)**

Sweeping legislation in California now requires agents selling annuities to disclose specific facts regarding penalties and tax consequences of selling or liquidate existing to buy annuity contracts, e.g., withdrawal penalties for cashing in a bank CD ahead of maturity, etc. In addition, there is a new requirement that clients sign a disclosure form pertaining to the relationship of a client’s potential annuity purchase and Medi-Cal eligibility.

Two bills mandated a series of written disclosures that must be made prior to selling annuities to seniors in California. *Assembly Bill 2107, Scott, effective July 1, 2001 (Included in Section 789.8 of the California Insurance Code)* requires life agents to make specific disclosures in writing to any person 65 or older. Under this Bill, a senior is defined as a person *aged 65 and over*.

**DISCLOSURE REGARDING THE SALE OR LIQUIDATION OF ASSETS TO PURCHASE ANNUITIES**

This disclosure makes seniors aware that cost and tax ramifications may be involved when other financial assets are liquidated to purchase an annuity. This disclosure applies to a broad group of products, including stock, bond, IRA, certificate of deposit, mutual fund, annuity, or other asset to fund the purchase of an annuity. This disclosure also advises a senior that they may wish to seek independent legal or financial advice before purchasing an annuity.

**DISCLOSURE REGARDING MEDI-CAL ELIGIBILITY**

The sale of annuities for “Medi-Cal” planning is one reason for the new legislation. Any agent who offers or sells any financial product on the basis of its treatment under the Medi-Cal program is required to present this disclosure. This disclosure makes seniors aware of the provisions and regulations of the Medi-Cal program and the determination of the elder's eligibility for Medi-Cal.

**DISCLOSURES REGARDING IN-HOME MEETING WITH SENIORS**

*Senate Bill 620, Scott, effective September 29, 2003 (Section 789.10 of the CIC)* this Bill requires life agents to make both written and verbal disclosures when meeting any person 60 or older in their home.

**WRITTEN DISCLOSURE REGARDING IN-HOME MEETING WITH A SENIOR.**

In the past agents often misrepresented the true nature of meetings as “financial planning” when their goal was to sell annuities. This disclosure notifies the senior of their rights, provides a list of attendees, and clearly communicates that an insurance sales presentation will be made. *This disclosure must be provided no less than 24 hours prior to meeting in the senior’s home.* If the senior requests a meeting with an agent the same day, the agent must present the notice upon arrival.

**VERBAL DISCLOSURE REGARDING IN-HOME MEETING WITH A SENIOR.**

In addition to the written disclosure, the agent is also required, upon arriving in the senior’s home, to make three verbal disclosures before proceeding. These include:

- The meeting's purpose is to discuss insurance;
- The name and titles of all persons in attendance; and
- The name of the insurer represented, if known.

Following the verbal disclosure, the agent must provide the senior with a business card (or other written identification) including their name, business address, telephone number and insurance license number.
2. Product specific illustrations (e.g. sales aides) (Section 1725.5, 10127.11 of the CIC)

AGENT'S RESPONSIBILITY PRESENTING ILLUSTRATIONS (CIC 1725.5 AND 10127.11)

Advertising and Illustrations

In addition to prominently displaying their agent license number on advertisements, illustrations and letterhead / business cards, effective 1/1/05 agents selling annuity contracts are now required to print the word "Insurance" in the same venues (Section 1725.5 CIC). Past abuses leading buyers to believe annuities were pension plans or aggressive investment opportunities are the reason for this new requirement.

Illustrations that accompany annuity contract sales to seniors must now include a disclosure in concerning the inability to predict future interest rates and values of annuity contracts and the illustrations that portray them.

VARIABLE ANNUITY ILLUSTRATIONS

For variable annuities, the NASD has addressed this issue and responded with established standards that agents must adhere to when creating illustrations and proposals. Because these illustrations and proposals (or more likely, the software programs that generate them) are provided by insurers, the agent need not be overly concerned with them in practice. As background, though, some information is useful. A proposal or an illustration cannot show growth in a variable annuity and compare it to a non-tax-deferred investment unless the annuity also is shown on an after-tax basis in the same illustration. Hypothetical performance cannot be used to illustrate future values; however, an assumed interest rate can be used to project values into the future. A subaccount's past performance can be used to paint a retrospective picture.

FIXED ANNUITY ILLUSTRATIONS

For fixed annuities, states as well as the NAIC have developed guidelines for illustrations. Agents are accustomed to using illustrations when presenting annuity concepts, often using software to generate illustrations.

Agents duties under California's Insurance Code when presenting illustrations are:

First, any annuity illustration showing values which are not guaranteed must contain the following disclaimer (ref. CIC, Section 10127.11):

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

Other aspects of the disclaimer:

- Disclaimer must be in 12-point bold print with at least one-half inch of space on all four sides
- Columns illustrating guaranteed value must appear in bold print
- Columns illustrating projected values must appear in standard print

Written price quotations for insurance products must include the agent's license number in a type the same size as any phone number, address, or fax number shown (CIC, Section 1725.5). After January 1, 2005, written price quotations must also include the word "Insurance" in type size at least as large as the largest phone number.
Agent's Responsibility Presenting Illustrations (Sections 1725.5 & 10127.11 of the CIC)

Because the annuity is an investment product, it lends itself to being sold by illustration and projections. And because of market conduct issues and the potential for misuse of product illustrations, intentional or not, extreme care must be taken with respect to what can and should be illustrated and projected. Illustrations are also regulated by law.

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3. Replacement (Section 10509.4, 10509.8 of the CIC)

Agent's Responsibility To Comply With Replacement Guidelines (Sections 10509.4 and 10509.8 of the CIC)

The exchange of one annuity for another has come under considerable scrutiny and criticism in recent years based on questionable suitability of some of the exchanges. Studies show that a large percentage of the annuities sold replaced previous annuities. Regulators are concerned with inappropriate "churning" of annuities which are designed to be held long-term.

According to statistics compiled by the National Association of Variable Annuities during the calendar year 2002, approximately $113.7 billion in variable annuity (VA) sales was recorded by the 25 largest annuity writers in the United States (source: NAVA Outlook, March/April 2003). Of one product to another.

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The trend to exchange has been noticeable for years and the National Association of Securities Dealers (NASD) issued an investor alert in early 2001 regarding the wisdom behind exchanging one variable annuity policy for another. In January 2004, the NASD charged a large broker/dealer with allegedly switching 6,700 variable annuity policies, of which 1,400 were likely to lose money.

Source: NASD website, 2004

In California, life agents who replace annuities or life insurance with new annuities have certain basic responsibilities that apply to the general population. (Section 10509.4) When an agent takes an application for an annuity, a statement must be provided to the insurer signed by both the agent and the applicant indicating whether replacement of an existing annuity or life insurance contract is involved. In the event replacement is involved, the agent has the following additional requirements:

- Present the applicant with the Notice Regarding Replacement at the time the application is taken. The Notice Regarding Replacement must:
  - List all existing life insurance and annuity contracts to be replaced
  - Properly identify the insurer, contract number(s), and insured/owner
  - Be signed by both agent and applicant

- Leave the Notice Regarding Replacement with the applicant;
- Leave the applicant with a copy of all printed communications used during the presentation;
- Provide the replacing insurer with a copy of the completed Notice Regarding Replacement with the application.

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

Agents who are attempting to conserve a replacement, (Section 10509.4 of CIC) must leave any written or printed communications used to conserve the business with the applicant. Under Section 10509.8 of the California Insurance Code, a violation occurs if an agent recommends the replacement of an existing annuity when an inaccurate presentation or comparison of premiums, benefits, dividends and values are made. Agents must evaluate the replacement on the basis of whether all of these aspects are equal to or better than the existing annuity.

The State Of California is also concerned with annuities which are replaced unnecessarily. New definitions for "unnecessary replacement" contained in Section 10509.8 of the California Insurance Code and apply to anyone who is 65 year of age or older.

"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. Agents must be much more careful when working with replacements. Since stiffer fines for violations also went into affect agents are advised to keep good records to support recommendations involving replacements.

4. Importance of reviewing sample contracts

**IMPORTANCE OF READING THE CONTRACT**

Understanding the provisions of the contracts you sell can only be achieved by reading the contracts themselves. Agents should not be satisfied with a summary of the features since the wording of similar provisions can vary from one contract to another. This difference in wording can lead to substantially different outcomes for your clients.

**Specimen Policies (Sample Contracts)**

An insurance agent should never sell an important product like an annuity without first obtaining and understanding a specimen policy and outline of coverage from the insurer. One of the most important reasons to obtain them is the rapid evolution of products, policies and definitions, e.g., what is an “applicant”, “certificate”, “group policy”, etc. Selling without them is like operating a computer without help screens. Do not depend on the insurance company literature or illustrations to give all the information needed to properly evaluate a policy.

C. Appropriate advertising (Section 1725.5 of the CIC)

**APPROPRIATE ADVERTISING**

The cornerstone agent ethics is the handling and choice of company, product and sales presentation to best serve a client’s financial planning. As it relates to advertising, agents should provide sales materials that are clear as to purpose and honest and fair as to content per Section 1725.5 of the CIC. This also means prominently affixing their license number, phone and address to any printed material, illustration, price quote or advertisement. Violations start at $200 and go as high as $1,000.

Insurance Code §1725.5 which was added to the Insurance Code in 1995 by AB 702, Chapter 217 became effective on January 1, 1997. It requires licensees to include their license numbers on business cards, premium quotes and print advertisements for insurance products distributed exclusively in California. The statute applies only to life and disability insurance analysts, life agents, variable contact agents, insurance agents, insurance brokers, insurance solicitors, surplus line broker, special lines’ surplus line brokers, bail agents, bail permittees, bail solicitors, insurance adjusters, public insurance adjusters, motor club agents, and travel insurance agents.

1. General advertising (Section 1725.5 of the CIC)

Effective January 1, 2005, for purposes of Sections 32.5, 1625, 1626, 1724.5, 1758.1, 1765, 1800, 14020, 14021, and 15006, every licensee must prominently affix, type, or cause to be printed on business cards, written price quotations for insurance products, and print advertisements distributed exclusively in this state for insurance products its license number in type the same size as any indicated telephone number, address, or fax number. If the licensee maintains more than one organization license, one of the organization license numbers is sufficient for compliance.

In the case of transactors, or agent and broker licensees, who are classified for licensing purposes as solicitors, working as exclusive employees of motor clubs, organizational license numbers must be used.

Any person in violation of this section will be subject to a fine levied by the commissioner in the amount of two hundred dollars ($200) for the first offense, five hundred dollars ($500) for the second offense, and one thousand dollars ($1,000) for the third and subsequent offenses.

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The penalty will not exceed **one thousand dollars ($1,000)** for any one offense. These fines must be deposited into the Insurance Fund.

A separate penalty will not be imposed upon each piece of printed material that fails to conform to these requirements.

### a. Definition of advertisement: envelopes, stationary, business cards

#### DEFINITION OF ADVERTISEMENT: ENVELOPES, STATIONARY, BUSINESS CARDS (SECTION 787(k) OF CIC)

California requirements *(CIC 787)* are very specific about advertising directed at seniors (anyone age 65 or older):

For the purposes of this section, an advertisement 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.

An advertisement by the State's definition includes envelopes, stationary, business cards and any other form of media that describes or encourages the purchase of an annuity.

No insurer, agent, broker, solicitor, or other person or other entity shall solicit persons age 65 and older in this state for the purchase of disability insurance, life insurance, or annuities the status, character, or proprietary or representative capacity of the entity or person, or to the true purpose of the advertisement.

Further, advertisements shall not employ **words, letters, initials, symbols, or other devices which 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.
- No advertisement may **use the name of a state or political entity** in a policy name or description.
- No advertisement may use any name, service mark, slogan, symbol, or any device in any manner that implies that the insurer, or the policy or certificate advertised, or that any agency who may call upon the consumer in response to the advertisement, is **connected with a governmental agency**, such as the Social Security Administration.

It is also important that any advertising you employ does not imply that the reader may **lose a right, or privilege, or benefits** under federal, state, or local law if he or she fails to respond to the advertisement.

Further, an insurer, agent, broker, or other entity may not use 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.

Likewise, no insurer may use, in the trade name of its insurance policy or certificate, any terminology or words that are 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.

No insurer, agent, broker, or other entity may solicit a particular class by use of advertisements which state or imply that the occupational or other status as **members of the class** entitles them to reduced rates on a group or other basis when, in fact, the policy or certificate being advertised is sold on an individual basis at regular rates.
Also remember, all advertisements used by agents, producers, brokers, solicitors, or other persons for a policy of an insurer shall have **written approval of the insurer before they may be used.**

Any person or entity that is not required to be licensed and non-resident agents representing an insurer that is a direct response provider **is exempt** from these rules.

### Required information to be displayed

**REQUIRED INFORMATION TO BE DISPLAYED**

If the goal is to generate leads, an advertisement must indicate that an agent will **contact** the prospect if that is the fact. Additionally, when the agent makes initial contact with a prospect generated from a lead, the agent must disclose that the contact is the result of a lead generating device. If the advertisement mentions a specific product, written approval by the insurer must be provided prior to use.

**Internet Sales**

A person who is licensed in this state as an insurance agent or broker, advertises insurance on the Internet, and transacts insurance in this state, shall identify all of the following information on the Internet, regardless of whether the insurance agent or broker maintains his or her Internet presence or if the presence is maintained on his or her behalf:

- His or her name as it appears on his or her insurance license, and any fictitious name approved by the commissioner.
- The state of his or her domicile and principal place of business.
- His or her license number.

A person shall be deemed to be transacting insurance in this state when the person advertises on the Internet, regardless of whether the insurance agent or broker maintains his or her Internet presence or if it is maintained on his or her behalf, and does any of the following:

- Provides an insurance premium quote to a California resident.
- Accepts an application for coverage from a California resident.
- Communicates with a California resident regarding one or more terms of an agreement to provide insurance or an insurance policy.

**Use of the word “insurance”**

Also effective January 1, 2005 the word **“Insurance”** must be included on these same documents, in type no smaller than the largest phone number (Section 1725.5 of CIC).

Every licensee must prominently affix, type, or have printed on their business cards, written price quotations for insurance products, and print advertisements, distributed in California for insurance products, the word **“Insurance”** in type size that is no smaller than the largest indicated telephone number.

The only exception here is if the failure to comply was beyond the control of the agent. In addition, this requirement does not apply to general advertisements of motor clubs that merely list insurance products as one of several services offered by the motor club, and do not provide any details of the insurance products.
iii. License number

LICENSE NUMBER

Business cards, written price quotations, and print advertisements must contain the agent's **license number** in type the same size as any indicated phone number, address, or fax number.

Every licensee shall prominently affix, type, or cause to be printed on business cards, written price quotations for insurance products, and print advertisements distributed exclusively in this state for insurance products its **license number** in type the same size as any indicated telephone number, address, or fax number. If the licensee maintains more than one organization license, one of the organization license numbers is sufficient for compliance with this section.

b. Seminars, classes, informational meetings

SEMINARS, CLASSES, INFORMATIONAL MEETINGS

Seminars as an effective way to sell to seniors are growing in popularity. Senate Bill 620 requires specific language in any advertisement for an event where insurance products will be offered for sale. Some agents believe the new language is not required if no selling is done at the meeting. If seminar is an eventual means to make annuity presentations or sales, the language is required.

In addition to any other prohibition on untrue, deceptive, or misleading advertisements, no advertisement for an event where insurance products will be offered for sale may use the terms "seminar," "class," "informational meeting," or substantially equivalent terms to characterize the purpose of the public gathering or event unless it adds the words **"and insurance sales presentation"** immediately following those terms in the same type size and font as those terms.

i. Required information to be displayed

REQUIRED INFORMATION TO BE DISPLAYED

Seminars include classes, workshops, informational meetings or any other substantially equivalent terms to imply a meeting. **All of the above requirements and restrictions discussed apply, with one addition.**

ii. Use of the word “insurance”

USE OF THE WORD “INSURANCE”

Immediately following the word "seminar," "class," "informational meeting," or any other words used to imply a meeting, the agent must now include the words (in the same type size and font) "and insurance sales presentation."

iii. License number

LICENSE NUMBER

Business cards, written price quotations, and print advertisements must contain the agent's license number in type the same size as any indicated phone number, address, or fax number.

c. Direct mailers

DIRECT MAILERS (SECTION 787, 1ST PARAGRAPH)

- An advertisement cannot contain the name of a state or political subdivision in the policy name or description.

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• An agent, booker, insurer, or other entity cannot use an address that misleads or deceives the
senior with regards to its actual location, true identity, or licensing status.

Any advertisement or other device designed to produce leads based on a response from a potential
insured which is directed towards persons age 65 or older shall prominently disclose that an agent may
contact the applicant if that is the fact. In addition, an agent who makes contact with a person as a
result of acquiring that person’s name from a lead generating device shall disclose that fact in the initial
contact with the person. So, if an agent’s product or way of operating requires an onsite visit or return
phone call to a senior, agents need to disclose that they will be contacting them.

d. Advertisements, coverages, and advertisers may not in any way imply a product is
endorsed by or related to any government agencies (Section 787 of the CIC)

Advertisement may not look like government agency, non-profit or senior organization

• An advertisement cannot contain words, letters, initials, symbols or other devices, which are
similar to those used by governmental agencies, senior organizations, charitable and nonprofit
institutions or other insurers if they would confuse or mislead seniors.

Coverage not provided or endorsed by government agency, non-profit or senior organization

• An advertisement cannot imply that the reader could lose rights, privileges, or benefits provided
by a federal, state, or local law if the reader fails to respond.

Advertiser is not connected with government agency, non-profit or senior organization

• An advertisement cannot contain any name, service mark, slogan, symbol or other device that
would imply the agent, insurer or policy is connected with a governmental agency, such as the
Social Security Administration.

Coverage or advertiser is not related to government agency

• A policy or certificate’s name cannot mislead, deceive, or confuse a prospective purchaser by
using words similar to a governmental program or agency.

e. Fines and penalty

FINES AND PENALTIES

AGENTS

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. Upon a second violation, an agent will be 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. In addition, if the commissioner brings an action against a licensee
for the violations above and determines that he may reasonably be expected to cause significant harm to
seniors, the commissioner may suspend his or her license pending the outcome of a hearing.

INSURERS

Any insurer who violates this article is liable for an administrative penalty of ten thousand dollars
($10,000) for the first violation. Second violations can bring a $30,000 to $300,000 fine and a rescission
of the annuity or policy in violation.

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Here are the penalties for any infractions related to these rules:

- Any person in violation of this section shall be subject to a fine levied by the commissioner in the amount of two hundred dollars for the first offense, five hundred dollars for the second offense, and one thousand dollars for the third and subsequent offenses. The penalty shall not exceed one thousand dollars for any one offense. These fines shall be deposited into the Insurance Fund.
- A separate penalty shall not be imposed upon each piece of printed material that fails to conform to the requirements of this section.
- If the commissioner finds that the failure of a licensee to comply with the provisions of subdivision (a) or (b) is due to reasonable cause or circumstance beyond the licensee's control, and occurred notwithstanding the exercise of ordinary care and in the absence of willful neglect, the licensee may be relieved of the penalty in subdivision (d).
- A licensee seeking to be relieved of the penalty in subdivision (d) shall file with the department a statement with supporting documents setting forth the facts upon which the licensee bases its claims for relief.
- This section does not apply to any person or entity that is not currently required to be licensed by the department or that is exempted from licensure.
- This section does not apply to general advertisements of motor clubs that merely list insurance products as one of several services offered by the motor club, and do not provide any details of the insurance products.
- This section does not apply to life insurance policy illustrations required by Chapter 5.5 of Part 2 of Division 2 or to life insurance cost indexes required by Chapter 5.6 of Part 2 of Division 2.

SEE ATTACHMENT III

2. Specific advertising to seniors (Section 787 of the CIC)

SPECIFIC ADVERTISING TO SENIORS (SECTION 787 OF THE CIC)

Deceptive advertising and deceptive lead generation are not allowed in California. Straightforward, accurate, and truthful information benefits both companies and the consumer by establishing credibility, security, and trusting relationships. Consumers, especially those over age 65, should not be misled or deceived by advertising.

California Insurance code CIC.787 says, “All insurers, brokers, agents, and others engaged in the transaction of insurance owe a prospective insured who is 65 years of age or older, a duty of honesty, good faith, and fair dealing. This duty is in addition to any other duty, whether expressed or implied, that may exist. Conduct of an insurer, broker, or agent, or other person engaged in the transaction of insurance, during the offer and sale of a policy or certificate previous to the purchase is relevant to any action alleging a breach of the duty of good faith and fair dealing.”

To be sure that companies and agents are not violating California’s regulations, it’s important to be aware of California Code that addresses these issues.

EFFECTIVE JANUARY 1, 2004 Applies To Seniors Aged 65 and Older SB 620 requires agents to adhere to strict guidelines when advertising to senior citizens. These provisions of the Code better protect seniors from misleading, deceptive, or confusing advertising practices. The new law includes several measures to prevent misleading advertisements, including advertisements that imply incorrectly that a particular insurer or insurance product is endorsed by any governmental agencies, non-profit or charitable organizations.

Section 787 of California Code requires that advertisements and direct mail used to produce leads must include wording that tells them that an agent may contact them if they respond.

Code 787 states, “Any advertisement or other device designed to produce leads based on a response from a potential insured which is directed towards persons age 65 or older shall
prominently disclose that an agent may contact the applicant if that is the fact. In addition, an agent who makes contact with a person as a result of acquiring that person's name from a lead generating device shall disclose that fact in the initial contact with the person.”

Also, solicitations cannot be made using misleading or deceptive names that do not divulge the true nature of the person or company.

California Insurance Code section 787 states, “No insurer, agent, broker, solicitor, or other person or other entity shall solicit persons age 65 and older in this state 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.”

There are also specific references to the means agents must observe and comply with.

CIC.787 says, “An advertisement 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 may imply that the reader may lose a right, privilege, or benefits under Federal, state, or local law if they fail to respond to the advertisement.

An insurer, agent, broker, or other entity may not use an address with the intention of misleading a consumer; they cannot conceal the true identity, location, or licensing status of the insurer, agent, broker, or other entity.

No insurer may use any terminology or words similar to those of a governmental agency or governmental program; it will confuse, deceive, or mislead a prospective purchaser.

All advertisements used by agents, producers, brokers, solicitors, or other persons must have written approval of the insurer before they can be used.

No insurer, agent, broker, or other entity may solicit a particular class by using advertisements that imply that the occupational status of those class members make them eligible for reduced rates.

For the benefit of California consumers, there are specific rules, regulations, and requirements regarding license numbers and the word “insurance;” specific information must be indicated and there are penalties for not complying with those regulations.

As of January of 2005, every licensee must prominently display the word insurance on their price quotes for insurance products on their business cards and on print advertisements that are distributed in California. The word insurance must also be in a type size that is no smaller than the largest indicated telephone number.

Every licensee must also prominently display their license number on anything related to their products. The license number must be in a type that is the same size as the phone number, address, or fax number displayed on the same advertisement. If the agent has more than one organization license, only one of the license numbers must be displayed. Agents who are classified as solicitors must use their organizational licensee numbers.

The Code requires specific language to be used in advertisements for meetings where annuities and/or insurance products will be offered as part of the program. Consumers who are invited to public or private venues for gaining information are entitled to know in advance the real purpose of the meeting.

In addition to any other prohibition on untrue, deceptive, or misleading advertisements, no advertisement for an event where insurance products will be offered for sale may use the terms "seminar," "class," "informational meeting," or substantially equivalent terms to characterize the purpose of the public gathering or event unless it adds the words "and insurance sales presentation" immediately following...
those terms in the same type size and font as those terms. There are a lot of mailings going out to consumers and especially to seniors in California. The Code says that “any advertisement or other device designed to produce leads based on a response from a potential insured which is directed towards persons age 65 or older” must do certain things.

The code says that they must “prominently disclose that an agent may contact the applicant if that is the fact.” In addition, if an “agent who makes contact with a person as a result of acquiring that person's name from a lead generating device,” they “must disclose that fact in the initial contact with the person.”

Some agents exempt are exempt: Any person or entity that is exempt from licensure or non-resident agents representing an insurer that is a direct response provider are considered exempt. According to section 785 of the California Insurance Code, the following are exempt:

- Medicare supplement insurance
- Long-term care insurance
- Disability coverage provided through the insured's employer or former employer
- Disability insurance policies or certificates principally designed to provide coverage for accidents or expenses incurred while traveling, if the premium for the policy or certificate is ten dollars or less
- Blanket disability insurance
- Credit disability insurance
- Accidental death insurance
- Disability policies or certificates that are sold through direct response methods of delivery
- Disability income insurance
- Provided that the requirements of Section 10296 are met, this article shall not apply to transportation ticket policies and baggage insurance policy types allowable for sale by travel agents

There are stiff penalties and fines for violations of this section. This is important because it prevent agents and companies from stepping over the line.

Because of the regulations and fines, California consumers can feel more reassured knowing that there are repercussions and financial penalties for those who might take advantage of them. This is especially important for seniors who are often the target of misleading promotions and advertising.

According to California code, here are the penalties and fines for violations:

- 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.
- 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 and no more than fifty thousand dollars for each violation.
- 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.
- Any insurer who violates this article is liable for an administrative penalty of ten thousand dollars for the first violation.
- 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 and no more than three hundred thousand dollars for each violation.
The commissioner may require rescission of any contract found to have been marketed, offered, or issued in violation of this article.

D. Prohibited sales practices

Prohibited Sales Practices

1. Selling annuities for Medi-Cal eligibility (Section 789.9 of the CIC)

Selling annuities for Medi-Cal eligibility (Section 789.9 of the CIC)

Selling annuity to persons 65 years and older for purpose of qualifying for Medi-Cal is prohibited if:

a. Selling annuity to persons 65 years and older for purpose of qualifying for Medi-Cal is prohibited if:

Medi-Cal and Annuities

For years, agents have seized on the fears of client's regarding Medi-Cal eligibility. Clients have been sold considerable product that purportedly exempts income or assets from the eligibility rules so as to believe they will qualify for Medi-Cal when the time comes. Many of these exemption holes have been plugged and there are penalties for people and their agents who attempt to abuse the system.

New legislation makes it very clear that a life agent who offers for sale or sells a financial product to an elder 65 years or older 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 (Section 789.9 of the CIC).

"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 needs 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 Exemptions

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 who is not connected with the sale of this product.

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

Dated:_____________ Signature: ___________________________________________ "

ANNUITIES USED TO AFFECT MEDI-CAL ELIGIBILITY (Section 789.9 of CIC)

More Medi-Cal Restrictions

An annuity shall not be sold to a senior (age 60 years and older) in any of the following circumstances:

The senior's purpose in purchasing the annuity is to affect Medi-Cal eligibility and either of the following is true:

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• The purchaser's assets are equal to or less than the community spouse resource allowance established annually by the State Department of Health Services pursuant to the Medi-Cal Act.
• The senior would otherwise qualify for Medi-Cal.
• The senior's purpose in purchasing the annuity is to affect Medi-Cal eligibility and, after the purchase of the annuity, the senior or the senior's spouse would not qualify for Medi-Cal.

If an annuity is issued but violates any of these provisions, the insurer must 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.

EFFECTIVE JANUARY 1, 2004 Applies To People 65 Years and Older Currently, a California resident may be eligible to receive nursing home benefits from Medi-Cal if they fall below certain asset thresholds. Under very special circumstances, annuities can sometimes be used to qualify seniors for nursing home benefits under Medi-Cal by reducing non-exempt assets. A non-exempt asset is counted when Medi-Cal evaluates eligibility, while an asset is not counted. Annuity sales to seniors that are supposed to help the senior qualify for Medi-Cal assistance are prohibited, if the senior's purpose in purchasing the annuity is to affect Medi-Cal eligibility and

i. If assets are equal to or less than community spouse resource allowance

If assets are equal to or less than community spouse resource allowance

• the senior's assets are equal to or less than the Medi-Cal community spouse resource allowance ($115,920 as of January 1, 2013) or

ii. Senior otherwise qualifies

Senior otherwise qualifies

• the senior would otherwise qualify for Medi-Cal or

iii. After purchase senior or spouse does not qualify for Medi-Cal

After purchase senior or spouse does not qualify for Medi-Cal

• after the purchase of the annuity, the senior or the senior's spouse would not qualify for Medi-Cal.

If a senior purchases an annuity in order to qualify for Medi-Cal, and the senior or the senior's spouse still does not qualify after the purchase, then the senior may cancel the annuity and receive a refund. If the senior has purchased a fixed annuity, then he or she will be refunded all premiums, fees, interest earned, and any other costs that were paid for the annuity. If the senior has purchased a variable annuity, then the senior will be refunded the account value.

2. In-Home Solicitations: 24-hour Notice requirement for persons 65 years and older (Section 789.10 of the CIC)

In-Home Solicitations: 24-hour Notice requirement for persons 65 years and older

The new regulations prohibit any agent from selling an annuity in the residence of senior (in person or by phone) through the use of any scheme that hides the true status mission of the contact. This is designed to protect seniors from abusive marketing schemes, like living trust mills.

In-home solicitations have been the source of senior abuse for years. Now there are specific legislative criteria that addresses this area of annuity sales.
Any person who meets with a senior (anyone age 65 or older) 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.

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:

**In-Home Solicitation Form**

(1) 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): ________________

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

(3) You have the right to end the meeting at any time.

(4) 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)

(5) 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, i.e. you cannot misrepresent the true content of the meeting, or to gather information for a follow-up visit to sell insurance, if that is the case, and state all of the following information:

(1) The name and titles of all persons arriving at the senior's home.

(2) 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.

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.

**a. Criteria**

**MISREPRESENTING THE CONTENT OF AN IN-HOME PRESENTATION (Section 789.10 CIC)**

This section applies to the sale, offering for sale, or generation of leads for the sale of life insurance, including annuities, to senior insureds or prospective insureds by any person.

Any person 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. 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**

| i. For persons 65 years and older |

### IN-HOME PRESENTATIONS (Section 789.10 of CIC)

#### WRITTEN DISCLOSURE

A new disclosure must be delivered prior to meeting in a senior's home which may lead to an annuity sale or sales presentation. The notice must be delivered in writing no less than 24-hours prior to the meeting. If the senior is already a client and requests a meeting the same day, notice must still be furnished before the meeting begins. The new disclosure notifies the senior of their rights, provides information about the attendees, and communicates the type of insurance sales presentation that will be made.

#### VERBAL DISCLOSURES

In addition to the written disclosure, the agent is also required to follow new guidelines upon arriving in the senior's home. Besides a greeting, three verbal disclosures must be provided before proceeding. These include:

- The meeting's purpose is to discuss insurance; and
- The name and titles of all persons in attendance; and
- The name of the insurer represented, if known

### b. Content of written notice

#### Content of written notice

The new law requires that before an insurance agent visits a senior's home to sell an annuity or life insurance, the agent must provide written notice in 14-point type that the senior will be given a sales presentation on life insurance, annuities, or other insurance products.

#### Sample Pre Meeting Notice

The notice below must be provided to the senior at least 24 hours before insurance solicitation takes place in the senior's home. It must have the appropriate information inserted, must be printed in 14-point type, and must provide the following information:

| (1) 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): __________________. |
| (2) You have the right to have other persons present at the meeting, including family members, financial advisors or attorneys. |
| (3) You have the right to end the meeting at any time. |
| (4) 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) |
| (5) The following individuals will be coming to your home: (list all attendees, and insurance license information, if applicable) |
The notice must also:

- List the names of others who will accompany the agent to the meeting, and provide their insurance license information, if applicable.
- Advise the senior that the senior may invite family members, attorneys, or financial advisors to attend the meeting, and that the senior may end the meeting at any time.
- List the names of others who will accompany the agent to the meeting, and provide their insurance license information, if applicable.
- Advise the senior that the senior may invite family members, attorneys, or financial advisors to attend the meeting, and that the senior may end the meeting at any time.

### c. Can not misrepresent true content of meeting

**Cannot misrepresent true content of meeting**

When the meeting in the home begins, the agent must state that the purpose of the meeting is to talk about insurance, or to gather information for a follow-up visit to sell insurance, if that is the case.

### 3. Sharing commissions with attorney (Section 1724 of the CIC)

**NEW REGULATIONS ON SHARING COMMISSIONS WITH ATTORNEYS (CIC 1724)**

EFFECTIVE JANUARY 1, 2004 Senate Bill 620 also clarifies commission-sharing agreements between attorneys and agents. An agent or broker may not share a commission or other compensation (including a bonus, gift, prize, award or finder's fee) with an active member of the California bar, unless the agent or broker is also an active member of the California bar. The intent of this provision is to discourage marketing schemes like living trust mills and the use of annuities in Medi-Cal planning where an agent would share his commission with the attorney. This section of the new law prevents California attorneys from recommending life insurance or annuities to seniors and then referring them to insurance agents in return for a share of the commission or other compensation.

> “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. For purposes of this section, “commission or other compensation” means 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.”

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.

For purposes of this section, “commission or other compensation” means pecuniary (consisting of money) 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.

### 4. Unnecessary replacement (Sections 10509.8 and 10509.914 of the CIC)

**ADDITIONAL REPLACEMENT DEFINITIONS (Section 10509.8 of CIC)**

EFFECTIVE JANUARY 1, 2004 Applies to People 65 and Older Another section of the new law prohibits agents from using materially inaccurate presentations to persuade seniors to purchase replacement policies. Agents often receive a commission when a policyholder replaces an older policy or annuity with a new one. Often a replacement policy or annuity starts a new period of several years when it cannot be surrendered without penalty.

Agents selling annuities must be more diligent than ever when the sale involves replacement. A new violation for *unnecessary replacement* where seniors aged 65 and older are concerned occurs if an agent...
recommends the replacement of an existing annuity with an inaccurate presentation or comparison of premiums, benefits, dividends and values are made. Agents must evaluate replacement on the basis of several aspects, not just interest rates. The agent must carefully assess the potential benefit of the proposed annuity when comparing it to a senior's existing annuity. Agents must determine that the benefits of the proposed annuity are equal to, or better than, the existing contract before making the sale. Agents must be sure to keep good records to support replacement recommendations and be able to justify that the replacement was in the insured's best interests.

Replacement (CIC 10509.8)

While the replacement of one annuity with another is not a bad thing, the introduction of new restrictions make it clear the Department of Insurance wants focus on abuses. Agents who are particularly aggressive in this area should exercise extreme caution in the presentation and implementation of a replacement contract.

a. Define "unnecessary replacement"

Define "unnecessary replacement"

For purposes of this section, "unnecessary replacement" means the sale of an annuity to replace an existing annuity that requires the insured to 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.

In the case of an annuity, an unnecessary replacement is defined as one that:

i. Pay a surrender charge

Pay a surrender charge

• requires the insured to pay a surrender charge for the annuity that is being replaced and

ii. Define substantial financial benefit

Define substantial financial benefit

• does not confer substantial financial benefit over the life of the new annuity to the purchaser (so that a reasonable person would believe that the purchase is unnecessary).

b. Examples of unnecessary replacement

Examples of Unnecessary Replacement

• The proposed annuity contains a lower interest rate than the replacement annuity and all other provisions are equal.
• The existing annuity features a guaranteed interest rate while the replacement annuity does not and all other provisions are equal.
• The existing annuity has better settlement options than the replacement immediate annuity and all other provisions are equal.
• Replacing a guaranteed rate annuity with an equity indexed or variable annuity, and all other provisions are equal.

c. Replacement of annuities including individuals over 65 years of age or older

Replacement for Age 65 and Older
Under new code sections, agents are in violation of California law if they recommend the replacement of an existing contract by use of a materially inaccurate presentation or comparison of an existing contract's premiums and benefits or dividends and values or annuity to a person age 65 or older.

SECTION 10509.914 (2012) In recommending annuities to individual consumers, including consumers over the age of 65, for purchase or exchange, the insurance producer (or insurer where no producer is involved) must have reasonable grounds for believing that the recommendation is suitable for the individual consumer on the basis of the facts disclosed by the individual consumer as to his or her investments and other insurance products and as to his or her financial situation, needs and objectives and reasonable belief of the following:

- The consumer has been reasonably informed of various features of the annuity, such as the potential surrender period and surrender charge, potential tax penalty if the consumer sells, exchanges, surrenders, or annuitizes the annuity, mortality and expense fees, investment advisory fees, potential charges for and features of riders, limitations on interest returns, insurance and investment components, and market risk.
- The consumer would receive a tangible net benefit from the transaction.
- The particular annuity as a whole, the underlying subaccounts to which funds are allocated at the time of purchase or exchange of the annuity, and riders and similar product enhancements, if any, are suitable, and in the case of an exchange or replacement, the transaction as a whole is suitable, for the particular consumer based on his or her suitability information.
- In the case of an exchange or replacement of an annuity, the exchange or replacement is suitable, including taking into consideration all of the following: Whether the consumer will incur a surrender charge, be subject to the commencement of a new surrender period, lose existing benefits, such as death, living, or other contractual benefits, or be subject to increased fees, investment advisory fees, or charges for riders and similar product enhancements; whether the consumer would benefit from product enhancements and improvements; whether the consumer has had another annuity exchange or replacement and, in particular, an exchange or replacement within the preceding 60 months.
- Prior to the execution of a purchase, exchange, or replacement of an annuity resulting from a recommendation, an insurance producer, or an insurer where no producer is involved, must make reasonable efforts to obtain the consumer's suitability information.
- Except as permitted, an insurer must not issue an annuity recommended to a consumer unless there is a reasonable basis to believe the annuity is suitable based on the consumer's suitability information. The preceding sentence notwithstanding, neither a producer nor an insurer must in any event recommend to a person 65 years of age or older the sale of an annuity to replace an existing annuity that requires the insured to pay a surrender charge for the annuity that is being replaced, where purchase of the annuity does not confer a substantial financial benefit over the life of the policy to the consumer, so that a reasonable person would believe the purchase is unnecessary.

5. Bait and switch

BAIT AND SWITCH

Bait & Switch schemes are marketing methods that misrepresent the true intent of an insurance sales presentation. For example, if a client is invited to a seminar about long-term care insurance, but the true intent is to sell annuities, the Department Of Insurance could deem this a violation.

Less than ethical agents use the illusion of providing a benefit to soften a client's perspective and then sell them something else. This is the classic definition of bait and switch. Many times the procedure is to qualify potential victims through a process of a deceptive interview or application . . . referred to as a pretext interview . . . with the sole purpose to gather confidential information. Often, clients are coerced into providing information under the guise of some potential benefit and once the information is retrieved, a product sales pitch is tailored.

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a. Pre-text interview-definition and examples

PRETEXT INTERVIEWS (Section 791 CIC)

Specific insurance codes have also been established to address these illegal activities:

Section 791.03 of CIC prohibits any agent or insurer from using pretext interviews to obtain information that will be used to transact insurance. California's seniors have been subjected to very misleading sales practices involving pretext interviews. The California Insurance Code defines pretext interviews as "an interview whereby a person, in an attempt to obtain information about a natural person, performs one or more of the following acts:

- Pretends to be someone he or she is not;
- Pretends to represent a person he or she is not in fact representing;
- Misrepresents the true purpose of the interview;
- Refuses to identify himself or herself upon request."

b. Long term care sales

Long Term Care Sales

Unfortunately agents sometimes use bait and switch tactics to sell long-term care insurance as well. They also bait people with LTC presentations, then attempt to sell annuities.

Other groups have seen the financial success of the trust-annuity sales gimmick, and adopted it as their model. Some are using a slightly different approach – they offer advice on long-term care planning, including Medi-Cal. Their real motivation, however, is still to sell annuities. They only give part of the picture, and stress that some annuities don't count as assets under Medi-Cal's eligibility rules. Agents are selling lots of unsuitable annuities this way, and getting paid large commissions.

c. Unauthorized practice of law-drafting, delivering, interpreting legal documents (Section 6125 of the Business and Professions Code)

Unauthorized practice of law-drafting, delivering, interpreting legal documents (Business and Professions Code 6125)

In 1999, the case of the People vs. Fremont Life Insurance Company went to trial in Los Angeles Superior Court. The determinations were as follows:

- "The insurer was involved in and responsible for the unauthorized practice of law by its agents in marketing estate plans.
- "Section 6125 of Business and Professions Code clearly states, "No person shall practice law in California unless the person is an active member of the State Bar."
- Agents do not have the authority to draft, deliver, or interpret legal documents such as wills or trusts.

The State Bar was involved in the suit a result of claims that representatives of the Alliance for Mature Americans, the organization that did the actual marketing, were engaged in the unauthorized practice of law.

It is important that agents do not represent themselves as having skills they do not possess in order to make a sale. The trust mill was just one example of this. Others include the practice of drafting, delivering and interpreting legal documents if you are unqualified to do so. An agent who decides to offer legal advice could be determined to practicing law without a license . . . a clear violation of the California Business and Professions . . . No person shall practice law in California unless the person is an active member of the State Bar.

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Therefore, areas such as estate planning, eldercare planning Medi-Cal planning and tax planning should be left to the professionals who are trained to advise in these fields.

6. Cause for suspension (Section 1668.1 of the CIC)

Suspension (CIC 1668.1)

The State of California is serious about agents using their position to influence or misrepresent clients . . . especially senior citizens. That is the focus of SB 620 and SB 618. As such, new legislation has given the Commissioner the "teeth" to enforce illegal agent activities. One such method is license suspension or revocation.

Existing law prohibits a person from soliciting, negotiating, or effecting contracts of insurance, or acting in the capacity of various types of insurance agents, unless the person holds a valid license from the Insurance Commissioner authorizing the person to act in that capacity.

Existing law authorizes the commissioner to deny an application for a license for various reasons.

The new law goes much further by authorizing the commissioner to suspend or revoke any permanent license issued if:

A 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.

Suspension, revocation and/or monetary penalties may also be assessed against any licensed agent who:

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 induced a client, whether directly or indirectly, to make the licensee or any of the persons listed in subdivision 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, OR 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, OR . . .

Use a power of attorney granted by client has to purchase an insurance product on behalf of the client for which the licensee has receives a commission, OR induces the client to provide the benefits for 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.

The exception to these rules is the case where transactions by the licensee are on behalf of a person related to the licensee by birth, marriage, or adoption; or a person who is registered as a domestic partner of the licensee.

NEW GROUNDS FOR REVOKING OR SUSPENDING A LICENSE CIC 1668.1

SB 618 increases the fines against insurers and agents for misrepresentation and fraudulent activities. It also protects seniors from an agent who induces them to co-sign or make a loan, make an investment or a gift or provide any future benefit to the agent (with some exceptions). Likewise, with certain exceptions, an agent cannot persuade or recommend to a senior that the senior make the agent a beneficiary of the senior's will, life insurance policy or annuity. Under Section 1668.1 of the California Insurance Code, the following acts may subject an agent to revocation or suspension of license:
## a. Loans

**Loans**

An agent cannot induce a client to:

- cosign or make a loan,
- make an investment,
- make a gift or
- provide a future benefit through the right of survivorship.

## b. Agent beneficiaries, trustee, and power of attorney

### Agent beneficiaries

- An agent cannot induce a client to name the agent as the owner or beneficiary of any life insurance or annuity contract.
- This restriction also applies to naming the agent as beneficiary of any trust.

### Agent as trustee

- An agent cannot induce a client to name the agent as a trustee to any trust, unless the agent is an attorney and does not sell insurance to the trust.

### Agent as power of attorney

- An agent with power of attorney for a client cannot use such authority to purchase insurance on behalf of the client, unless no commission is paid to the agent.

## c. Benefits payable to family or friends of agent

**Benefits payable to family or friends of agent**

It will also be considered a violation of Code if any one of the following parties is named in place of the agent:

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

### i. Exceptions

**Exceptions**

If the client is related to the agent (by birth, marriage or adoption) or is registered as a domestic partner of the agent, the above provisions do not apply.

## 7. Penalties (Section 782, 789.3, 1738.5, 10509.9 of the CIC) (Attachment III)

**Penalties (CIC 782, 789.3, 1738.5, 10509.9)—See Attachment III**

The seriousness of the new legislation is also underscored in the penalties assessed for violations:
Misrepresentation of Policy Terms or Benefits *(Section 780, 781, 782, 789.3 CIC)*

Misrepresentation of policy terms, benefits, privileges, dividends; or to induce someone to buy one policy then sell another; or to mislead someone to forfeit his policy based on a false comparison is a crime and punishable by a fine not exceeding $25,000 or 3 times the amount lost by the victim and / or by imprisonment not exceeding one year. The commissioner may also require rescission of any contract found to have been marketed, offered, or issued in violation of this article.

**Duplicate, Unnecessary Coverage / Deceptive Advertising (Section 1738.5, 10509.9 CIC)**

Seniors who are abused via inaccurate, duplicated or unnecessary coverage. Or, who are deceived by an agent representing himself to be someone he is not will results in still penalties, including an administrative penalty of no less than five thousand dollars ($5,000) for the first violation; $5,000 to $50,000 for a second violation. If the Commissioner at anytime believes the agent can be reasonably expected to cause harm to seniors, his license may be suspended.

Further violations for the same offense can result in another $10,000 fine for the agent and from $30,000 to $300,000 for the insurer. Further, based on the outcome of a hearing, the agent's license could be suspended or revoked.

**Informed Decision / Reasonable Replacements**

Annuity buyers are entitled to information to make an informed decision and the reasonable expectation that the consequences of a replacement of their existing policy is made. Agents not providing this are subject to an administrative penalty of no less than one thousand dollars ($1,000) for the first violation; $5,000 to $50,000 for a second violation. If the Commissioner at anytime believes the agent can be reasonably expected to cause harm to seniors, his license may be suspended. Further violation can result in another $10,000 fine for the agent and form $30,000 to $300,000 for the insurer. Further, based on the outcome of a hearing, the agent's license could be suspended or revoked.

**Failure to Refund a Contract Refund To a Senior**

Seniors (age 60 and older) are now entitled to a 30-day free look and a total refund of their premiums. Insurers that fail to make these refunds in a timely manner will pay the applicant interest from the date the insurer or entity received the returned policy or certificate.

**Day in Court**

Any allegations of misconduct perpetrated against a person age 65 or over shall result in a hearing to be held within 90 days after receipt by the department of the notice. Based on the outcome of a hearing, the agent's license could be suspended or revoked.

**(SEE ATTACHMENT III)**

**Suspension or Revocation by the Commissioner CIC.1738.5**

The commissioner may suspend or revoke an agent's permanent insurance license for failure to comply with all the regulations surrounding the sale of annuities. The commissioner may, without hearing, deny an application if the applicant has:

- Committed a felony as shown by a plea of guilty or nolo contendere, or by a final judgment of conviction thereof
- Committed a misdemeanor denounced by this code or by other laws regulating insurance as shown by a plea of guilty or nolo contendere, or by a final judgment of conviction thereof
- Had a previous application for a professional, occupational, or vocational license denied for cause by any licensing authority, within five years of the date of the filing of the application to be acted
upon, on grounds that should preclude the granting of a license by the commissioner under this chapter

- Had a previously issued professional, occupational, or vocational license suspended or revoked for cause by any licensing authority, within five years of the date of the filing of the application to be acted upon, on grounds that should preclude the granting of a license by the commissioner under this chapter. In the event the commissioner issues an order based on a plea that does not at any time result in a judgment of conviction, the commissioner shall vacate the order upon petition by the applicant. CIC.1669

E. The importance of determining client suitability for annuity sales (Section 10509.915 of the CIC). For example:

ANNUITY SUITABILITY

In the world of insurance annuities, client's must decide when to invest, what to invest and how much. As an agent, it is your job to analyze needs and be an advocate or problem solver to make sure the requested benefits are delivered.

A client views annuity contracts in terms of obtaining future benefits, i.e., in most cases, your customers can only hope that the contract they purchase is appropriate. That is why agents are vital players in solving client needs. The greater agent due care exercised, the more valuable the service.

There are variety of techniques that are accepted and used to determine customer needs or suitability. Some are more traditional than others. Most are seen as solutions to identify a certain customer segment. They give logical, rational explanations about where the customer fits in but do not explain how the customer feels and cares. Contract applications are an example of information an agent might use to identify who he is about to invest.

SUITABILITY

In California, agents and consumers have many choices, each with its own unique subset of features and provisions.

“Suitability” is defined as a sale or recommendation that “meets the needs and goals of a person based upon reasonable inquiry concerning the person's insurance objectives, financial situation, age and other relevant information”.

Annuities are available in a variety of shapes and sizes. Immediate, deferred, fixed, indexed, variable, single-premium, flexible premium. By matching a client's needs and resources with these variables, an annuity can be designed to fit almost any situation. To meet the criterion of suitability, the recommendation of a given annuity must be appropriate for any particular client in light of his or her financial objectives, circumstances, and needs. Whether an annuity is suitable for your client depends on a variety of factors, which are often interconnected. As an agent, solving the suitability equation is the result of gathering critical information and knowledge.

- The agent should have a solid foundation of the issues surrounding annuities in general.
- The agent should understand the provisions, features, and limitations of the annuity they sell.
- The agent should take time to understand the client's unique circumstances including, but not limited to, financial status, tax status and investment objectives.

In general, any annuity purchaser should have a need and desire for long term accumulation and should be able to afford the annuity premium. In addition, the annuity owner should generally not expect to need to withdraw funds from the annuity in the near future. For variable annuities, the purchaser should also have a need and desire for the growth potential offered by securities, and a willingness to accept the risk that accompanies that potential for growth. One of the agent's most important responsibilities is to make sure a potential buyer thoroughly understands the features, benefits and drawbacks of a financial product before he or she commits to its purchase. Financial professionals who sell variable annuities have a duty
to advise clients as to whether the product they are trying to sell is suitable to their particular investment needs.

For the variable annuity sale, the agent should ensure that the client understands the following:

- Risk to principal
- Fluctuating investment returns
- No guaranteed growth
- Premium payment options or requirements
- Subaccount investment options and the risk they entail
- Asset allocation and diversification
- Reallocation options
- Tax deferral
- Surrender charges (how long they last and how much they are)
- Free withdrawal provisions, if any
- IRS penalties for early withdrawals
- Tax treatment of withdrawals
- Tax treatment of annuitization
- Death benefit guarantee
- Annuitization options
- Fees and charges, including the mortality and expense charge

**SUITABILITY – AGE, TAX & FINANCIAL STATUS, INVESTMENT OBJECTIVES**

**THE NAIC’S SUITABILITY MODEL**

The concern over annuity suitability is growing, not just in California but nationwide. The NAIC believes that the states should apply the suitability standards of the securities industry to fixed and registered insurance products, and that both the producer and the insurer should play a role in determining suitability.

In connection with their increased scrutiny of annuity sales, the National Association of Insurance Commissioners (NAIC) a national association of state insurance regulators, have developed a model regulation that will govern required disclosures in the sale of annuities. The model creates standards for both agents and insurers to be sure that the insurance needs and financial objectives of senior consumers are appropriately addressed whenever the sale of an annuity is recommended to a senior (65 years or older).

**Recommendations for Required Disclosures in Annuity Sales:**

- Identification of the product as an annuity
- Identification of the issuing insurer
- Specific description of when surrender charges apply
- Explanation of how the current interest rate will be credited, the period during which the initial rate applies, the guaranteed minimum rate, and how future interest rates will apply
- Statement regarding availability of a death benefit
- Description of the effect of current tax law on annuity accumulations and withdrawals
- Statement of any other policy charges and fees

Under the NAIC Senior Protection in Annuity Transactions Model Act and Model Regulation, a “senior” consumer was defined as a person sixty-five years of age or older.

A number of insurers and trade organizations filed comments and participated in several conferences of the NAIC Life and Annuity (A) Committee which resulted in significant changes to the Model Regulation. On September 14, the Model Regulation was adopted by the full NAIC. It imposes a suitability standard on insurance producers, and insurers that is patterned after NASD Conduct Rule 2310, requiring that agents have reasonable grounds for believing that the recommendation is suitable 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. Insurers are required to either establish and maintain a system to supervise recommendations that is reasonably designed to achieve compliance with the regulation, or contract with a third party, including a general agent or independent agency, to maintain such supervisions with respect to insurance providers under contract with or employed by the third party. Finally, the Model Regulation authorizes the insurance commissioner of a state to order an insurer,
insurance producer and/or general or independent agency to take reasonably appropriate corrective action for any senior consumer harmed by the insurer's or insurance producer's violation.

| 1. Identify the need for information prior to making recommendations |

**Annuity Suitability & Seniors**

In 2003, the National Association of Insurance Commissioners (NAIC) adopted the new *Senior Protection Annuity Transactions Model Regulation* (SPATMR) The purpose of this action is to establish guidelines for insurers and producers for determining suitability standards for fixed and variable annuities sold to senior consumers. These guidelines are available for various states to adopt and or modify in creating new suitability legislation which many do not currently have.

Key elements of SPATMR include the following:

- The model regulation creates standards and procedures for producers to follow when making annuity recommendations to individual seniors (over age 65) who are considering the purchase or exchange of a fixed or variable annuity.
- The model requires agents to make a **reasonable effort** to obtain information on a senior's financial, tax and investment objectives.
- The model establishes that producers must have **reasonable grounds** for recommending an annuity on the basis of facts disclosed by the consumer.
- The model establishes procedures to supervise and enforce compliance by producers through review of selling documents, training and period audits.

**Identifying Need**

The message of the NAIC and any suitability effort is the importance of identifying the need to gather information **prior or before** making any recommendation. At a minimum, this information should include information on the **client’s financial status**, such as:

- **Income**: What is the annuity prospect's current income? What are his needs in the future? What other sources of income are present today? Tommorrow?
- **Liquid Assets**: What is the prospect's ratio of cash to hard assets? Is it adequate? How will this change in the future? Will purchasing an annuity negatively effect his liquidity?
- **Long Term Care**: Does the prospect have a plan for long term care in place? Does he understand the need to have one before investing elsewhere? What other sources could help care for a long term care illness?
- **Tax Status**: What is the prospect's tax bracket? Considering this, is an annuity advantageous or not? How will the future change his tax status?
- **Investment Objectives**: Where does the prospect see himself in 10 years? 20 years? Is he realistic? If so, does he need to emphasize growth or income to get there? Does he have time to meet his goals? Is the prospect financial sophisticated? Is he capable of monitoring an investment plan such as a variable annuity?
- **Life Insurance**: Does the prospect have life insurance? Is it adequate?
- **Other Information**: Has the prospect taken advantage of retirement plan options available to him at work? Why not? Does he understand how they benefit him? Does he have time to create a meaningful plan? What is the prospect's tolerance for risk? What is the prospect's tolerance for insurance products? Non-insurance products?

**Need For Full Contract Disclosure**

Matching contract terms to client needs is another important aspect of determining suitability. Full disclosure of terms, surrender charges, expenses and important issues such as cash surrender benefits or death benefits that fall short of minimum nonforfeiture amounts are the only way your client can make decisions.
an informed decision to proceed. Most contracts should have critical omissions like this prominently displayed in the policy. If not, it is your responsibility to bring them up. How will you know? Obtain specimen policies for every product you plan to offer. Carry them with you to show disclosures and to understand that all features of the contract are in line with your customer needs and objectives.

Record Keeping

Annuity contracts, like variable annuities, can be quite complex. You will need to stress to your client that he keep accurate records of subaccount investment choices as well as their performance.

CRITERIA FOR ASSESSING ANNUITY SUITABILITY WITH SENIORS

Purchasing an annuity should entail looking at a senior's total financial picture, both today and into the future as well. The NAIC has identified four criteria which should be evaluated prior to making a recommendation.

- **Criteria 1.** The senior's financial status;
- **Criteria 2.** The senior's tax status;
- **Criteria 3.** The senior's investment objectives; and
- **Criteria 4.** Other information which may be a consideration regarding the purchase.

### a. Age of the consumer

The older the client is, the more conservative the investment strategy must be. Older clients, aka seniors, have much less time to make-up for bad investment decisions or get rich quick schemes. Especially when dealing with lengthy surrender periods or other fees and charges that will diminish the amount available for the investor.

The other implication is tying up income of younger clients who may need these funds before age 55 and may be subject to additional penalties in order to access their money.

### b. Financial status of the consumer

Purchasing an annuity usually means making a long-term commitment; one that carries costs (i.e. surrender charges) if the senior is forced to prematurely surrender the contract for such reasons as a change in financial status. That is why it is so important to take time early on to understand the senior's current financial status and how that may be likely to change during the term of an annuity. It is important to evaluate these considerations from a present and future perspective.

#### i. Income

Consider the senior's income needs. Many seniors live on a strict budget and rely on multiple sources of income to sustain lifestyle. Agents should verify that seniors have additional resources to supplement additional income needs in the short-term.

#### ii. Liquid assets

Liquid assets

Are the senior’s liquid assets sufficient, and does the amount they intend to invest represent too great a portion of the senior's total liquid assets? Most financial experts agree that seniors should have liquid assets equal to or at least 6 months of living expense.
Comprehensive LTC Insurance in place?

Consider the senior's other financial needs. Does the senior have a complete financial plan, including long-term care insurance for example? Are there other expected short-term financial contingencies - like owing income tax on the sale of a home - that might take priority over the purchase of an annuity?

c. Tax status of the consumer

THE CONSUMER'S TAX STATUS

Annuities provide special tax advantages. Earnings receive the benefit of tax-deferral while they remain in the annuity. And where non-qualified annuities are concerned, the income stream from a settlement option is also tax-advantaged.

The annuity's distributed earnings and interest will receive ordinary tax treatment

While annuity funds accumulate tax deferred within the contract, on withdrawal or distribution their earnings are subject to tax as ordinary income, not capital gains. The buyer's tax bracket should be considered, as well as that of the beneficiary who would be responsible for the income tax due on the earnings upon the death of the owner or annuitant. Agents should also consider the senior's tax status before recommending an annuity.

d. Investment objectives of the consumer

THE CONSUMER'S INVESTMENT OBJECTIVES

Due to design innovations, annuities can accommodate a broad range of investment objectives. Still, the benefits of an annuity may not always be compatible with the senior's financial objectives.

The senior's risk tolerance and return expectations

With a choice of fixed, equity-indexed and variable annuities, agents can usually help satisfy the senior's risk tolerance and reward expectations. Knowing which type of annuity is most suitable requires a solid understanding of the products themselves. As agents, it is important to help consumers make reasoned and personal decisions when it comes to evaluating which type of annuity is most suitable. Riskier investments usually translate to higher potential for return while conservative investments offer lower reward potential. The same can be said for fixed, equity-indexed and variable annuities. Seniors, in particular, tend to be especially sensitive to this issue since many of them may rely on their annuity for income at some point in the future.

The senior's investment horizon

It is important that the surrender period of the proposed annuity coincides with the date the senior wants to access or annuitize the funds. Many annuities on the market today have surrender periods of 10 years or more. If the senior anticipates a five-year horizon, a 10-year surrender period may not be suitable due to the surrender charge.

The senior's liquidity needs

Although most annuities contain some liquidity provisions they are not a major source of liquidity. If the senior needs more than the contract allows, a costly surrender charge applies. In this event, another investment vehicle might be more suitable than an annuity.
The investment frequency

If the client wants to make systematic deposits into an annuity, the contract must be structured to accept additional deposits once it has been opened. A flexible premium deferred annuity vs. a single premium deferred annuity would be advisable under these circumstances.

e. Other information to be used or considered relevant

OTHER INFORMATION TO BE USED OR CONSIDERED RELEVANT

Making suitable recommendations requires an educated agent to use their comprehensive product knowledge to match solutions with the needs of their client. The State's new training requirements provide agents with the fundamental knowledge required to help make suitable recommendations. Agents must continually seek additional training in order to stay on top of the many changes in the annuity marketplace. Buyer's guides are available from the NAIC to help consumers make informed decisions. The California Department of Insurance also has a buyers guide on their web site (www.insurance.ca.gov).

2. Discuss the required record keeping (CIC 1759.3, 10509.914(e) and 10509.915)

THE NEED FOR COMPLETE RECORD KEEPING

Recordkeeping of the information collected from the purchasers of annuities during the process of determining suitability of the recommendation is also highly encouraged by the NAIC act. This would allow the commissioner to be provided with appropriate information for monitoring compliance and resolving complaints.

SECTION 10509.914 (2012)

In recommending annuities to individual consumers including consumers over the age of 65, for purchase or exchange, the insurance producer (or insurer where no producer is involved) must have reasonable grounds for believing that the recommendation is suitable for the individual consumer on the basis of the facts disclosed by the individual consumer as to his or her investments and other insurance products and as to his or her financial situation, needs and objectives and reasonable belief of the following:

• The consumer has been reasonably informed of various features of the annuity, such as the potential surrender period and surrender charge, potential tax penalty if the consumer sells, exchanges, surrenders, or annuitizes the annuity, mortality and expense fees, investment advisory fees, potential charges for and features of riders, limitations on interest returns, insurance and investment components, and market risk.
• The consumer would receive a tangible net benefit from the transaction.
• The particular annuity as a whole, the underlying subaccounts to which funds are allocated at the time of purchase or exchange of the annuity, and riders and similar product enhancements, if any, are suitable, and in the case of an exchange or replacement, the transaction as a whole is suitable, for the particular consumer based on his or her suitability information.
• In the case of an exchange or replacement of an annuity, the exchange or replacement is suitable, including taking into consideration all of the following: Whether the consumer will incur a surrender charge, be subject to the commencement of a new surrender period, lose existing benefits, such as death, living, or other contractual benefits, or be subject to increased fees, investment advisory fees, or charges for riders and similar product enhancements; whether the consumer would benefit from product enhancements and improvements; whether the consumer has had another annuity exchange or replacement and, in particular, an exchange or replacement within the preceding 60 months.
• Prior to the execution of a purchase, exchange, or replacement of an annuity resulting from a recommendation, an insurance producer, or an insurer where no producer is involved, shall make reasonable efforts to obtain the consumer's suitability information.

Except as permitted under subdivision (d), an insurer shall not issue an annuity recommended to a consumer unless there is a reasonable basis to believe the annuity is suitable based on the consumer's
suitability information. The preceding sentence and subdivision (d) notwithstanding, neither a producer nor an insurer shall in any event recommend to a person 65 years of age or older the sale of an annuity to replace an existing annuity that requires the insured to pay a surrender charge for the annuity that is being replaced, where purchase of the annuity does not confer a substantial financial benefit over the life of the policy to the consumer, so that a reasonable person would believe the purchase is unnecessary.

**Required Checklist**

10509.914(e) An insurance producer or, where no insurance producer is involved, the responsible insurer representative, shall at the time of sale do all of the following:

(1) Make a record of any recommendation subject to subdivision (a) of this section.

(These types of notes should be entered into the client's file or database and be accessible for reference or review by the State).

(2) Obtain a customer signed statement documenting a customer's refusal to provide suitability information, if any.

(This can be as simple as a handwritten sheet of paper, signed by the client stating that the client refuses to provide requested information. To limit suitability exposure this letter should disclose to the client that failure to provide the required information may limit the protections offered under the law. Check with your compliance department before making or using any such form.)

(3) Obtain a customer signed statement acknowledging that an annuity transaction is not recommended if a customer decides to enter into an annuity transaction that is not based on the insurance producer's or insurer's recommendation.

An agent may be absolved of the suitability requirements if the client refuses to give the agent the required information, the client provides false or incomplete information, or the client chooses to purchase annuities against the recommendation of the agent.

**Insurer Responsibilities**

Under 10509.914 of the California Insurance Code, responsibilities also apply to insurers as follows:

An insurer shall establish a supervision system that is reasonably designed to achieve the insurer's and its insurance producers' compliance with this article, including, but not limited to, all of the following:

(A) The insurer shall maintain reasonable procedures to inform its insurance producers of the requirements of this article and shall incorporate the requirements of this article into relevant insurance producer training manuals.

(B) The insurer shall establish standards for insurance producer product training and shall maintain reasonable procedures to require its insurance producers to comply with the requirements of Section 10509.915.

(C) The insurer shall provide product-specific training and training materials which explain all material features of its annuity products to its insurance producers.

(D) The insurer shall maintain procedures for review of each recommendation prior to issuance of an annuity that are designed to ensure that there is a reasonable basis to determine that a recommendation is suitable. The review procedures may apply a screening system for the purpose of identifying selected transactions for additional review and may be accomplished electronically or through other means, including, but not limited to, physical review. An electronic or other system may be designed to require additional review only of those transactions identified for additional review by the selection criteria.

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(E) The insurer shall maintain reasonable procedures to detect recommendations that are not suitable. This may include, but is not limited to, confirmation of consumer suitability information, systematic customer surveys, interviews, confirmation letters, and programs of internal monitoring. Nothing in this subparagraph prevents an insurer from complying with this subparagraph by applying sampling procedures or by confirming suitability information after issuance or delivery of the annuity.

**California Insurance Code Section 10509.914**

(a) In recommending to a consumer the purchase of an annuity or the exchange of an annuity that results in another insurance transaction or series of insurance transactions, the insurance producer, or an insurer if no producer is involved, shall have reasonable grounds for believing that the recommendation is suitable for the consumer on the basis of the facts disclosed by the consumer as to his or her investments and other insurance products and as to his or her financial situation and needs, including the consumer's suitability information, and that there is a reasonable basis to believe all of the following:

(1) The consumer has been reasonably informed of various features of the annuity, such as the potential surrender period and surrender charge, potential tax penalty if the consumer sells, exchanges, surrenders, or annuitizes the annuity, mortality and expense fees, investment advisory fees, potential charges for and features of riders, limitations on interest returns, insurance and investment components, and market risk.

(2) The consumer would receive a tangible net benefit from the transaction.

(3) The particular annuity as a whole, the underlying subaccounts to which funds are allocated at the time of purchase or exchange of the annuity, and riders and similar product enhancements, if any, are suitable, and in the case of an exchange or replacement, the transaction as a whole is suitable, for the particular consumer based on his or her suitability information.

(4) In the case of an exchange or replacement of an annuity, the exchange or replacement is suitable, including taking into consideration all of the following:

(A) Whether the consumer will incur a surrender charge, be subject to the commencement of a new surrender period, lose existing benefits, such as death, living, or other contractual benefits, or be subject to increased fees, investment advisory fees, or charges for riders and similar product enhancements.

(B) Whether the consumer would benefit from product enhancements and improvements.

(C) Whether the consumer has had another annuity exchange or replacement and, in particular, an exchange or replacement within the preceding 60 months.

(b) Prior to the execution of a purchase, exchange, or replacement of an annuity resulting from a recommendation, an insurance producer, or an insurer where no producer is involved, shall make reasonable efforts to obtain the consumer's suitability information.

(c) Except as permitted under subdivision (d), an insurer shall not issue an annuity recommended to a consumer unless there is a reasonable basis to believe the annuity is suitable based on the consumer's suitability information. The preceding sentence and subdivision (d) notwithstanding, neither a producer nor an insurer shall in any event recommend to a person 65 years of age or older the sale of an annuity that requires the insured to pay a surrender charge for the annuity that is being replaced, where purchase of the annuity does not confer a substantial financial benefit over the life of the policy to the consumer, so that a reasonable person would believe the purchase is unnecessary.

(d) (1) Except as provided under paragraph (2), neither an insurance producer nor an insurer shall have any obligation to a consumer under subdivision (a) or (c) related to an annuity transaction if any of the following occur:

(A) No recommendation is made.
(B) A recommendation was made and was later found to have been prepared based on materially inaccurate information provided by the consumer.

(C) A consumer refuses to provide relevant suitability information and the annuity transaction is not recommended.

(D) A consumer decides to enter into an annuity transaction that is not based on a recommendation of the insurer or the insurance producer.

(2) An insurer's issuance of an annuity subject to paragraph (1) shall be reasonable under all the circumstances which are actually known, or which after reasonable inquiry should be known, to the insurer or the insurance producer at the time the annuity is issued.

(e) An insurance producer or, where no insurance producer is involved, the responsible insurer representative, shall at the time of sale do all of the following:

(1) Make a record of any recommendation subject to subdivision (a).

(2) Obtain a customer-signed statement documenting the customer's refusal to provide suitability information, if any.

(3) Obtain a customer-signed statement acknowledging that an annuity transaction is not recommended if the customer decides to enter into an annuity transaction that is not based on the insurance producer's or insurer's recommendation.

(f) (1) An insurer shall establish a supervision system that is reasonably designed to achieve the insurer's and its insurance producers' compliance with this article, including, but not limited to, all of the following:

(A) The insurer shall maintain reasonable procedures to inform its insurance producers of the requirements of this article and shall incorporate the requirements of this article into relevant insurance producer training manuals.

(B) The insurer shall establish standards for insurance producer product training and shall maintain reasonable procedures to require its insurance producers to comply with the requirements of Section 10509.915.

(C) The insurer shall provide product-specific training and training materials which explain all material features of its annuity products to its insurance producers.

(D) The insurer shall maintain procedures for review of each recommendation prior to issuance of an annuity that are designed to ensure that there is a reasonable basis to determine that a recommendation is suitable. The review procedures may apply a screening system for the purpose of identifying selected transactions for additional review and may be accomplished electronically or through other means, including, but not limited to, physical review.

An electronic or other system may be designed to require additional review only of those transactions identified for additional review by the selection criteria.

(E) The insurer shall maintain reasonable procedures to detect recommendations that are not suitable. This may include, but is not limited to, confirmation of consumer suitability information, systematic customer surveys, interviews, confirmation letters, and programs of internal monitoring. Nothing in this subparagraph prevents an insurer from complying with this subparagraph by applying sampling procedures or by confirming suitability information after issuance or delivery of the annuity.

(F) The insurer shall annually provide a report to its senior management, including to the senior manager responsible for audit functions, which details a review, with appropriate testing, reasonably

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designed to determine the effectiveness of the supervision system, the exceptions found, and corrective action taken or recommended, if any.

(2) (A) Nothing in this subdivision restricts an insurer from contracting for performance of a function, including maintenance of procedures, required under paragraph (1). An insurer is responsible for taking appropriate corrective action, and may be subject to sanctions and penalties pursuant to Section 10509.916 regardless of whether the insurer contracts for performance of a function and regardless of the insurer's compliance with subparagraph (B). An insurer is responsible for the compliance of its insurance producer with the provisions of this article regardless of whether the insurer contracts for performance of a function required under this subdivision and regardless of the insurer's compliance with subparagraph (B).

(B) An insurer's supervision system under paragraph (1) shall include reasonable supervision of contractual performance under this subdivision. This includes, but is not limited to, both of the following:

(i) Reasonable monitoring and, as appropriate, conducting audits to ensure that the contracted function is properly performed.

(ii) Annually obtaining a certification from a senior manager who has responsibility for the contracted function that the manager has a reasonable basis to represent, and does represent, that the function is properly performed.

(3) An insurer is not required to include in its system of supervision an insurance producer's recommendations to consumers of products other than the annuities offered by the insurer.

(g) An insurance producer or insurer shall not dissuade, or attempt to dissuade, a consumer from any of the following:

(1) Truthfully responding to an insurer's request for confirmation of suitability information.

(2) Filing a complaint.

(3) Cooperating with the investigation of a complaint.

(h) (1) This subdivision applies to FINRA broker-dealer sales of variable and fixed annuities.

(2) Sales by FINRA broker-dealers that comply with the suitability and supervision system requirements set forth in FINRA Rule 2330, or any successor rule, shall satisfy the suitability and supervision system requirements of this article, provided that the suitability criteria used also include both of the following:

(A) The consumer's income.

(B) The intended use of the annuity.

(3) Except as provided in paragraphs (1) and (2), all other provisions of this article remain applicable to these broker-dealer sales.

(4) Nothing in this subdivision shall limit the commissioner's ability to enforce, including conducting investigations related to, the provisions of this article.

(5) “FINRA” means the Financial Industry Regulatory Authority or a successor agency.

California Insurance Code Section 10509.915

(a) An insurance producer shall not solicit the sale of an annuity product unless the insurance producer has adequate knowledge of the product to recommend the annuity and the insurance producer is in compliance with the insurer's standards for product training. An insurance producer may rely on insurer-provided product-specific training standards and materials to comply with this subdivision.

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of its contractual obligations to insured persons, subject to any restrictions in the written agreement between the insurer and administrator on the proprietary rights of the parties in the books and records.

(b) The commissioner shall have access to the books and records for the purpose of examination, audit, and inspection. Any information contained in the books and records, including, but not limited to, the identity and addresses of policyholders and certificateholders, shall be confidential, except the commissioner may use the information in any proceedings instituted against the administrator.

(c) The commissioner may, after notice and hearing, promulgate reasonable rules and regulations specifying the manner and type of records to be maintained by administrators.

(d) Every administrator shall keep and maintain the books and records required by this section and the regulations promulgated pursuant to this section. Failure to keep or maintain the books and records as required shall be grounds for the suspension or revocation of the certificate of registration of the administrator. The proceeding shall be conducted in accordance with Chapter 5 (commencing with Section 11500) of Part 1 of Division 3 of Title 2 of the Government Code.

F. Identify required disclosures (Attachment II)

Required Disclosures (AB 2107)

The thrust of the new annuity legislation is disclosure and suitability. Only then can you recommend a reasonable solution; only then can a client make an informed decision to purchase or pass.

Assembly Bill 2107 (2001) significantly strengthened disclosure in the selling of annuities . . . especially to seniors. This legislation requires agents to make specific disclosures about the consequences of financial transactions related to Medi-Cal eligibility. Many points of this legislation have already been discussed and the full text of this bill is included as Attachment II at the end of this course. To summarize:

- A special Notice Regarding Standards for Medi-Cal Eligibility is now required to be signed by the annuity buyer for any financial product geared to Medi-Cal or its eligibility.
- Agent conduct and history will be investigated and deemed to be relevant in any action or breach of duty concerning the selling of Medicare supplement insurance, long term care insurance, etc.
- The definition of senior financial abuse is expanded as well as the need for people who work among the elderly to act more responsibly by recognizing their rights to feel secure from abuse.
- Agents need to apprise seniors that the sale of existing assets or annuities in order to buy new ones can have negative tax consequences and associated penalties.

REQUIRED DISCLOSURES (AB 2107, Scott, Chapter 442, Statutes of 2001- Attachment III)

The primary determinant of full disclosure is whether the client has been provided, in an understandable manner, with all of the facts that are material to his or her purchase decision. Regulators say that the three main areas of deficiency in regard to annuity sales disclosure involve the following:

- Interest rates
- Surrender charges
- Tax implications

INTEREST RATES

An annuity is a long-term contract. Clients must understand that interest rates and market conditions change.
SURRENDER CHARGES

Clients must understand the period of time and the conditions under which surrender charges may be assessed as well as any exceptions such as “Free” withdrawals.

TAX IMPLICATIONS

Clients must understand that annuities earn interest on a tax deferred, not a tax-free basis. Taxes are due on annuity accumulations when they are paid out of the contract. Clients must also be aware of the 10% penalty tax to which withdrawals from the contract may be subject if they are made prior to age 59½, unless certain exceptions apply.

1. Discuss the need for full contract disclosure (Section 10168.7 of the CIC)

THE NEED FOR FULL CONTRACT DISCLOSURE (SECTION 10168.7 OF THE CIC)

Annuity products can be complex. The more complicated the product, the greater the chance that a client may not understand it fully. According to California Insurance Code (§785), agents owe a prospective client aged 65 or older a duty of honesty, good faith and fair dealing. The Department Of Insurance wants agents to assist seniors to make informed buying decisions.

To accomplish this, agents have an implied responsibility to provide full disclosure including advantages and disadvantages for the clients situation. Suitability demands that producers recommend only those products with which they are familiar and that they can explain easily. In addition, they should be able to discuss the financial strength and track record of the issuing insurers.

G. Policy cancellation and refunds (Section 10127.10, 10509.6 of the CIC)

POLICY CANCELLATION AND REFUNDS (SECTIONS 10127.10 AND 10509.6 OF THE CIC)

The California Insurance Code also creates new free-look language affecting variable annuities. While the old law provided for a 30-day “free look” period, the new law states that the annuity must be invested in fixed-income accounts during this 30-day period, so that a full refund can be made. By default, all premiums paid for a variable annuity will be allocated to fixed-income investments and money market funds during the free-look. This assures that all premiums paid will be refunded during the free-look period if the senior has a change of mind or circumstances. For this provision, a "senior" is someone age 60 or older. As an exception to this, the investor may direct the premium to be invested into the variable annuity's subaccounts immediately. However, if this is case, the senior is no longer guaranteed a full return of premium.

Senior citizens who purchase annuities must now be given the right to cancel them within 30 days. This law applies to all contracts sold and delivered after 1/1/04. Return of the policy during the cancellation period has the effect of voiding the policy from the beginning and placing the parties in the same position as if no policy had been issued. That means that all premiums and policy fees shall be refunded by the insurer. 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.

The new law makes it easier for seniors to receive a full refund if they cancel an annuity contract within 30 days after purchase. Annuity contracts issued to people aged 60 and older must contain a free-look provision. During the free-look, the policy owner may elect to return the policy in exchange for a full refund. In California, this time period may not be less than 30 days from the date of delivery to the policy owner.

The responsibility of the company includes safeguards for the consumer by including a 30-day “free look” cancellation / refund period, with differentiation made between and for fixed and variable annuity policies. This must be printed clearly on the policy. This is effective with policies sold 1/1/2004 with it being the provisions retroactive for policies sold after 1/1/2003.
For **fixed annuities**, a full refund of the amount paid must be returned if requested by the annuity owner within 30 days of receiving their contract. If not done in 30 days from the annuity owner’s request, the company is liable for interest to be paid on the money from the day of the receipt of the request by the annuity owner to the date of payment of the refund to the annuity owner.

**FOR VARIABLE ANNUITIES (Section 10127.10)**

For **variable annuities**, it is required that a customer’s money be held, during the 30 day period, in guaranteed instruments so that if a person exercises the cancellation in the 30 day period, they will get their initial premium back (unless the client specifically asks to have the money invested in the variable accounts).

If a variable annuity is involved, the owner, is entitled to a full refund of his account value. And, during the 30-day **free look** cancellation period the premium **must only be invested in fixed-income investments**.

**FIXED OPTIONS**

The owner of a **variable annuity** can transfer all or part of the value of their contract to the **fixed account**, sometimes called the guaranteed account. They might want to provide a safe harbor for a part or all of their funds held in their variable annuity in times of declining performance of all or one of their sub-accounts. If an owner wants to annuitize their fund values and have a guaranteed monthly lifetime income instead of a variable payout, they might transfer their money to the guaranteed fund and then elect to annuitize those funds. In essence, the variable annuity owner for a fixed dollar amount purchases a monthly income which will be paid to him/her until death.

Contracts when issued include an "annuity table" stating the minimum payout guaranteed by the company based on age and sex (according to state law). From the fixed account, when the contract is annuitized, the payout will be based on the higher value of the guaranteed amount stated in the table or the current values used at that time.

California Insurance Code also speaks to the **fixed accounts in variable annuities** during the **30-Day Free Look Period** after delivery of the annuity to the client. It states, in part, that “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.

If the owner does not direct investments to be made outside the fixed funds during the **Free Look Period**, they will receive all of their initial premiums back if they cancel during the **30 days**.

However, if the owner does direct that their initial premiums be invested in accounts other than the fixed accounts, then, if they cancel during the **30-day** period after delivery, they will receive the value of their account as of the day of the cancellation which may or may not be similar to what they paid in initially.  
*(Section 10127.10 of the CIC)*

**CIC.10127.10** Every policy of individual life insurance and every **individual annuity** contract that is initially delivered or issued for delivery to a **senior citizen** in this state on and after July 1, 2004, must have printed on it 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 set forth by the insurer for return of the policy by the insured shall be clearly stated on the notice and this period shall be not 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** must have 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. (b) This section applies to all individual policies issued or delivered to senior citizens in this state on or after January 1, 2004. All policies subject to this section which are in effect on January 1, 2003, shall be construed to be in compliance with this section, and any provision in any policy which is in conflict with this section shall be of no force or effect. (c)

3. 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 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 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, must 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 section 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 section shall not apply to contributory and noncontributory employer group life insurance, contributory and noncontributory employer group annuity contracts, and group term life insurance.

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.

1. Free look for persons 60 years and older (Section 786 of the CIC)

Free Look – 60 Years and Older

For purposes of this chapter, a senior citizen means an individual who is 60 years of age or older on the date of purchase of the policy.

Senior citizens who purchase annuities must now be given the right to cancel them within 30 days and receive a full refund. This law applies to all contracts sold and delivered after 1/1/04. Return of the policy during the cancellation period has the effect of voiding the policy from the beginning and placing the parties in the same position as if no policy had been issued. That means that all premiums and policy fees must be refunded by the insurer. 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 must receive interest on the paid premium at the legal rate of interest. If a variable annuity is involved, the owner is entitled to a full refund of his account value. And, during the 30-day free look cancellation period the premium must only be invested in fixed income investments.

These new rules are underscored by the need for every policy to print, in 12-point bold, the following disclaimers:

YOU HAVE PURCHASED AN ANNUITY CONTRACT. 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.

For variable annuity contracts, the disclaimer is slightly modified as follows:

THE 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 REFUNDBD 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 THE 30-DAYS MAY RESULT IN A SUBSTANTIAL PENALTY, KNOWN AS A SURRENDER CHARGE.

The free look provisions (CIC 786) apply to persons 60 years and older and do not apply to contracts sold through group plans.

2. Free look for persons younger than 60 years old (section 10127.9 of the CIC)

Free Look – Under Age 60 Years

Agents should know that clients over age 60, as well as persons younger than 60, who purchase annuities must now be given the right to cancel them within 30 days (786, 10127.9, 10127.10 CIC). This law, which supersedes similar legislation defining seniors as 65 years, applies to all contracts sold and delivered after 1/1/04. Return of the policy during the cancellation period has the effect of voiding the policy from the beginning and placing the parties in the same position as if no policy had been issued. That means that all premiums and policy fees must be refunded by the insurer. 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 must receive interest on the paid premium at the legal rate of interest.
X. SB 483, KUEHL (CHAPTER 379, STATUTES OF 2008) MEDI-CAL: HOME AND FACILITY CARE 10%

Medicaid is health insurance that helps many people who cannot afford medical care pay for some or all of their medical bills. Medi-Cal is the state’s version of the federal Medicaid program. Medi-Cal is financed with State, federal and some county funds. In order to be eligible for Medi-Cal, a person must have limited income and property, and meet certain other requirements. There are special rules for those who live in nursing homes and for aged, blind, or disabled individuals living at home who would, except for application of these special rules, require nursing facility services.

To be eligible for Medi-Cal, a person’s countable property may not exceed the established property reserve limits for the respective Medi-Cal program. Property is defined as “real property” and “personal property.”

SB 483 KUEHL -- ANNUITIES AND MEDI-CAL

- In California, SB 483 (2008) was enacted to bring California into compliance with provisions of the Deficit Reduction Act of 2006 which lengthened the “look-back” period for asset transfers to establish Medicaid’s eligibility for nursing home coverage from 3 to 5 years, requiring annuities to be disclosed and states to be named a remainder beneficiary for the cost of Medicaid assistance with certain specific exceptions. The bill would also deny Medi-Cal assistance to anyone who has a home equity limit of $750,000 or more. Then too, the bill allows anyone to demonstrate that the lack of Medi-cal assistance would establish an undue financial hardship exception.

- The annuity must be annuitized prior to applying for Medicaid. Many consumers who own deferred annuities will not remember that they must annuitize the policy prior to applying for Medicaid. Once the Medicaid applicant reveals that their annuity is a deferred annuity, then it’s too late. Medicaid (Social Services) will order the policy owner to either cash in the annuity for spend-down or simply disqualify the applicant for having assets that exceed the qualifying amount.

- If someone purchases an annuity for the purpose of protecting their money from nursing home spend down, there is no guarantee that Medicaid will not simply change their qualification rules in order to disqualify such Medicaid applicants. The government is an expert at changing the rules.

- Under the Kennedy Kassebaum and OBRA ’93 Act, an annuity must have life expectancy payout rates that are in accord with the latest social security mortality tables. Many insurance companies’ payout rates are not compliance.

- Some annuities will not allow them to annuitize the first year. Therefore, if their situation should require annuitization during the first year, they would simply be out of luck! (There are other annuities that will not allow annuitization for 5-15 years.)

- If a deferred annuity is purchased to shield assets against Medicaid, the purchaser will often make a spouse the annuitant, so that in the event of nursing home confinement, the deferred annuity can be annuitized with income going to the spouse. However, if the annuitant predeceases the annuity owner, the death benefit is triggered. In some cases, a surrender charge is charged upon the death of the annuitant. In addition, the owner of the annuity will receive notice from the IRS for the taxable gain, not a pleasant experience. Finally, since the spouse is usually the primary beneficiary, the proceeds will be made payable to the contingent beneficiary. This is most likely the children and not the owner of the policy. This scenario could cause exercise of the agent’s E&O.

- Many purchasers do not understand how Medicaid actually works and therefore are not qualified to engage in this type of planning.

- OBRA 93 established and mandated a 60-month look back for deferred annuities. Many State Medicaid offices use this provision to initiate or trigger the ineligibility penalty period, creating an array of problems that may ultimately be attributable to ownership of a deferred annuity.

- Using an annuitized annuity to shield assets loses its glitter when it comes to single individuals, since the annuitized income cannot be directed to another individual as with married couples and the income stops should the income recipient die.
• What happens when the annuitant simply dies? You cannot attempt to qualify for Medicaid by annuitizing their policy with the intention of passing excessive monies to their heirs. Under the Estate Recovery rules passed by OBRA 93, any income that continues to heirs after their death could be subject to recovery by Medicaid.
• It is worth considering that if they annuitize based on their life expectancy, the interest rate provided by the company may be quite low!
• If the annuity owner has to enter a nursing home because he has become incapacitated or mentally incompetent, who can make the decision to either gift the annuity policy or simply annuitize it? No one can, unless there is a durable power of attorney which grants such power. Even having a durable power of attorney is no guarantee, since many documents do not contain the requisite language for gifting or annuitizing such a policy.
• Agents cannot use a section 1035 exchange to avoid some of the problems mentioned above because this procedure requires that the owner and annuitant in the successor contract remain the same.

14002.5. For the purposes of this article, the following definitions apply:

"Annuity" means a contract that names an annuitant and gives a person or entity the right to receive periodic payments of a fixed or variable sum for a described period of time, which may include a lump-sum payment or periodic payments upon the death of the annuitant.

"Community spouse" means the spouse of an institutionalized spouse.

"Home and facility care" means the following services that are subject to Medi-Cal reimbursement:
- Nursing facility care services.
- A level of care in any institution equivalent to that of nursing facility care services.
- Home- or community-based care services furnished under a waiver granted pursuant to subsection (c) or (d) of Section 1396n of Title 42 of the United States Code.

"Institutionalized spouse" means any individual to whom all of the following apply:
- The individual is in a medical institution or nursing facility or is a person who is receiving institutional or noninstitutional services from an organization with a frail elderly demonstration project waiver pursuant to Chapter 8.75 (commencing with Section 14590), and is likely to meet that requirement for at least 30 consecutive days.
- The individual is married to a spouse who is not in a medical institution or nursing facility, or to a spouse who is not receiving services from any organization with a frail elderly demonstration project waiver pursuant to Chapter 8.75 (commencing with Section 14590).
- Except for purposes of Sections 14005.7, 14005.12, 14005.16, and 14005.17, an individual who is admitted to a medical institution or nursing facility on or after September 30, 1989, and who applies for Medi-Cal benefits on or after January 1, 1990, or a Medi-Cal recipient who is admitted to a medical institution or nursing facility on or after January 1, 1990.

"Medical institution" has the same meaning as defined in Section 435.1010 of Title 42 of the Code of Federal Regulations.

"Nursing facility" has the same meaning as defined in Section 1250 of the Health and Safety Code.

Section 14005 of the Welfare and Institutions Code is amended to read:

14005. The health care benefits and services specified in this chapter, to the extent that such services are neither provided under any other federal or state law nor provided nor available under other contractual or legal entitlements of the person, must be provided under this chapter to any person who is a resident of
this state and is made eligible by the provisions of this article. It is the intent of the Legislature that a provider must look to such other contractual or legal entitlements for payment before submitting a bill for payment under this chapter.

Any applicant for, or recipient of, Medi-Cal benefits who requests medical assistance for home and facility care must meet the specific eligibility requirements for the receipt of medical assistance for home and facility care set forth in this chapter.

Section 14006.01 is added to the Welfare and Institutions Code, to read:

14006.01. This section applies to any individual who is residing in a continuing care retirement community, as defined in paragraph (11) of subdivision (c) of Section 1771 of the Health and Safety Code, pursuant to a continuing care contract, as defined in paragraph (8) of subdivision (c) of Section 1771 of the Health and Safety Code, or pursuant to a life care contract, as defined in subdivision (l) of Section 1771 of the Health and Safety Code, that collects an entrance fee from its residents upon admission.

In determining an individual’s eligibility for Medi-Cal benefits, the individual’s entrance fee must be considered a resource available to the individual if all of the following apply:

- The individual has the ability to use the entrance fee, or the contract provides that the entrance fee may be used, to pay for care if other resources or income of the individual are insufficient to pay for care.
- The individual is eligible for a refund of any remaining entrance fee when he or she dies or terminates his or her contract with, and leaves, the continuing care retirement community.
- The entrance fee does not confer an ownership interest in the continuing care retirement community.

Section 14018 of the Welfare and Institutions Code is amended to read:

- The MEDI-CAL CARD must be authorization for payment for health care services rendered, during and subsequent to the month of application of a person eligible under Section 14005.1, or a person eligible under Section 14005.4 or 14005.7 who is certified by the department.
- The Medi-Cal card must be signed and dated in the space provided on the card by the beneficiary upon receipt of the card and prior to presentation of the card for any service. This paragraph must not apply to either of the following:
  - Persons 17 years of age and under.
  - Persons in long-term care.

Notwithstanding subdivision (a), any person with a Medi-Cal card who receives medical assistance for home and facility care may be ineligible for payment for periods of time, including partial months of ineligibility, as determined pursuant to Section 14015 and in accordance with Title XIX of the federal Social Security Act (42 U.S.C. Sec. 1396 et seq.).

A. Home equity limits (Section (c) of the Welfare and Institutions Code)

HOME EQUITY LIMITS SECTION 14006.15[c] OF THE WELFARE AND INSTITUTIONS CODE

The DRA was signed by President Bush in February 2006. The DRA makes several major changes to Medicaid long-term care services. Key changes include requiring states to lengthen the look-back period for asset transfers to establish Medicaid’s eligibility for nursing home coverage from 3 to 5 years, requiring annuities to be disclosed and states to be named a beneficiary for the cost of Medicaid assistance, and excluding Medicaid coverage for long-term care for individuals with home equity in excess of $500,000 (or up to $750,000 at state option), with an exception when a spouse or child with a disability is residing in the home.
ELIGIBILITY EXCLUSION AND HARDSHIP EXEMPTION

Prior to the enactment of the DRA, the value of an individual's home was not included in the determination of Medicaid eligibility (there was no maximum home equity limit).

Under the DRA, an individual is excluded from Medicaid eligibility for nursing facility and other long-term care services if he/she has a **home equity** exceeding $500,000 (or $750,000 if a state chooses). This implements the DRA by prohibiting an individual from being Medi-Cal eligible for home and facility care if his or her equity interest in the principal residence exceeds $750,000, adjusted over time based on CPI.

This also exempts an individual from the exclusion from eligibility for Medi-Cal home and community-based care if any of the following circumstances exist:

- a) 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, is lawfully residing in the individual's home;
- b) The individual was determined eligible for Medi-Cal home and facility care based on an application filed before January 1, 2006.
- c) DHCS determines that ineligibility for Medi-Cal home and facility care would result in demonstrated hardship on the individual. **Demonstrated hardship is defined to include, but not be limited to, any of the following:**
  - i) The individual was receiving home and facility care prior to January 1, 2006;
  - ii) The individual has been determined to be eligible for Medi-Cal home and facility care based on an application filed on or after January 1, 2006, and before the date that regulations adopted under this bill are certified with the Secretary of State;
  - iii) The individual purchased and received benefits under a long-term care insurance policy certified by DHCS' California Partnership for Long-Term Care Program (if FFP is unavailable to cover these individuals, state General Fund is required to be used);
  - iv) The individual's equity interest in the principal residence exceeds the equity interest limit of $750,000, but would not exceed the equity interest limit under if it had been increased by using the quarterly House Price Index for California, published by the Office of Federal Housing Enterprise Oversight;
  - v) The applicant or beneficiary has been denied a home equity loan by at least three lending institutions, or is ineligible for any one Federal Housing Administration approved loan or reverse mortgage; and,
  - vi) The applicant or beneficiary, with good cause, is unable to provide verification of the equity value; and,
  - vii) The applicant or beneficiary has an undue hardship, as defined.

The federal **Deficit Reduction Act of 2005 (DRA)**, provides that individuals who have **home equity** in excess of $500,000 are ineligible for payment by Medicaid for long-term care services and home or community based waiver services defined as **home and facility (HAF) care** in these regulations. The DRA, however, allows states to adopt statutes to raise the home equity cap up to $750,000. California raised the home equity cap to $750,000. This home equity cap applies only to an individual’s eligibility for payment of HAF care services. Individuals with excess home equity remain eligible for all other medically necessary Medi-Cal covered services. No later than December 31, 2011, and each year thereafter, DRA allows for an annual increase to the home equity limitation in an amount based on the percentage increase in the consumer price index for all urban consumers (all items, United States city average), rounded to the nearest one thousand dollars ($1,000).
There is an exception to the home equity limitation for individuals with a spouse, or a minor child (under 21), or a blind or disabled child residing in the home. Also, States cannot apply this provision in cases of documented hardship. The federal law prohibits states from denying payment of HAF care services if certain minimum criteria exist. States may expand their own definitions of undue hardship. SB483 (Chapter 379 of 2008) established the undue hardship criteria for this purpose. It is codified, in part, in Welfare and Institutions Code, section 14006.15.

The DRA and Welfare and Institutions Code (W&IC), section 14006.15, establishes California’s equity interest limit in the principal residence at $750,000 to be eligible for payment of HAF care. The limitation does not apply to the principal residence if the individual’s spouse, the individual’s child if under the age of 21, or a blind or disabled child lawfully resides in the home. Additionally, the limitation does not apply if the individual was determined eligible for Medi-Cal payment for HAF care if the application was filed prior to January 1, 2006. The limitation will also not apply if the department determines that ineligibility for Medi-Cal assistance would result in demonstrated hardship under specified circumstances.

B. Establishment of hardship exception (Section 14015.1, 10415.2 of the Welfare and Institutions Code)

ESTABLISHMENT OF HARDSHIP EXCEPTION (SECTION 14015.1, 10415.2 OF THE WELFARE AND INSTITUTIONS CODE)

14015.1 UNDUE HARDSHIP:

This legislation prohibits a person from being subject to a period of ineligibility for Medi-Cal for home and facility care at the time of the initial application or redetermination if DHCS determines that an undue hardship exists. It requires an undue hardship to exist under the following circumstances:

The department must consider, at initial application or redetermination, whether an undue hardship, as described in subdivision (b), exists prior to finding that an applicant or recipient is subject to a period of ineligibility for medical assistance for home and facility care pursuant to this article. No person must 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 must be found to exist 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 or relating to this section have been certified with the Secretary of State.
- 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.

The department must establish regulations, procedures, and forms that ensure all of the following:

- The department or county provides a notice of the undue hardship process, at the initial request and the annual redetermination, to any individual who requests medical assistance for home and facility care. The notice must inform the individual that undue hardship must be considered before a request for medical assistance for home and facility care is denied.
- A timely and simplified process is established to determine whether an undue hardship exists and an exception will be granted.

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• If the issue of UNDUE HARDSHIP is considered and found not to apply, the department must provide the individual with a notice of action that states the reasons for the adverse determination. The notice of action must specify how that adverse determination can be appealed. Upon the request of the applicant or beneficiary, or person acting on his or her behalf, undue hardship notices must be provided to the home and facility care administrator in accordance with regulations promulgated by the department.

14015.2

In accordance with Section 1917(c)(2)(D) of the federal Social Security Act (42 U.S.C. Sec. 1396p(c)(2)(D)), 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.

An individual with a pending undue hardship appeal who is subject to a period of ineligibility pursuant to this article must receive medical assistance for home and facility care for a maximum of 30 bed-hold days.

C. Look-back period (Section 14015(c) of the Welfare and Institutions Code)

LOOK-BACK PERIOD (SECTION 14015[C] OF THE WELFARE AND INSTITUTIONS CODE)

To qualify for Medi-Cal, a recipient must show he or she has limited resources available (generally, the limit for one person is $2,000). Current law requires states to review the assets of Medicaid applicants for a period of 36 months prior to application (this period is known as the "look back" period). Eligibility screeners look for asset transfers made during the look back period that appear to have been made primarily for the purpose of obtaining Medicaid eligibility.

Applicants are prohibited from transferring resources (such as giving cash gifts to children or other family members) during the look back period for less than fair market value. If a state eligibility screener finds a non-allowed transfer, current law requires the state to impose a "penalty period" during which Medicaid will not pay for long-term care.

Prior to the DRA, federal law required a 36-month "look back" for such gifts. However, California's Medi-Cal program never implemented the federal law, and it currently has a 30-month "look back" period. The DRA extends the "look back" period to 60 months for all gift transfers. This legislation amends existing state law by reference to federal law and regulations to extend the look back period to 60 months through the adoption of state regulations through the non-emergency APA.

14015. The providing of health care under this chapter must not impose any limitation or restriction upon the person’s right to sell, exchange or change the form of property holdings nor must 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 must, 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, 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.
• 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, must be treated as a transferred asset and may result in a period of ineligibility as described in

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paragraph (1), as required by Title XIX of the federal Social Security Act (42 U.S.C. Sec. 1396 et seq.) and any regulations adopted pursuant to that act.

Pursuant to Section 1917(c)(2)(C)(ii) of the federal Social Security Act (42 U.S.C. Sec. 1396p(c)(2)(C)(ii)), a satisfactory showing that assets transferred exclusively for a purpose other than to qualify for medical assistance must not result in ineligibility for Medi-Cal and must include, but not be 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 must 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 must not 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 must 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 must include, but are not limited to, wheelchairs and special hospital beds.

**D. Establishment of requirements related to annuities, designated beneficiaries, and California’s role as a remainder beneficiary of annuities (Section 14006.15[a][2], 14006.41[b], 14009.6 of the Welfare and Institutions Code)**

Establishment of requirements related to annuities, designated beneficiaries, and California's role as a remainder beneficiary of annuities (Section 14006.15[a][2], 14006.41[b], 14009.6 of the Welfare and Institutions Code)

The DRA 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 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.

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.
SECTION 14006.41 IS ADDED TO THE WELFARE AND INSTITUTIONS CODE, TO READ:

14006.41. To be eligible for medical assistance for home and facility care, an individual must disclose at the time of the individual’s application or redetermination a description of 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.

At the time of the individual’s application or redetermination, the department must 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 in Section 14009.6.

SECTION 14009.7 IS ADDED TO THE WELFARE AND INSTITUTIONS CODE, TO READ:

14009.7. If an annuity is considered part or all of the community spouse resource allowance allowed under subdivision (c) of Section 14006, the state must only become a remainder beneficiary of that portion of the annuity that is not a part of that community spouse resource allowance.

The state must 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 individual and/or the community spouse must bear the burden of demonstrating that the requirements of this section that limit the state’s right to become a remainder beneficiary, as described in Section 14009.6, are met.

The Department is promulgating this change to establish and implement Medi-Cal rules for the treatment of annuities, similar financial instruments and annuity-related transactions. These regulations are required by changes in State law prompted by passage of the federal Deficit Reduction Act (DRA) of 2005.

CURRENT RULES

In general, annuities are financial products that are purchased giving the buyer the right to periodic payments. For purposes of Medi-Cal eligibility, California Code of Regulations Title 22, Division 3, Section 50489(b)(1) defines an annuity as “a contract to make periodic payments of a fixed or variable sum paid to an annuitant which are payable unconditionally.

Annuity payments may continue for a fixed period of time or for as long as the annuitant lives.

An annuitant purchases an annuity with his or her property or property rights. Annuities must be established to provide the annuitant with payments representing principal and interest which are more than the fair market value of the property used to purchase the annuity.”
Under Medi-Cal rules, annuities are used to change what would otherwise have been excess countable property resulting in ineligibility for Medi-Cal into countable income that does not result in ineligibility. They are used most frequently by single institutionalized individuals who do not have the ability to transfer countable property to their spouses who are not institutionalized.

Annuities must be “annuitized” meaning that equal monthly payments must be received for a number of years that are less than or equal to the number of years of the annuitant’s life. If annuities are not properly annuitized, then the cash surrender value is counted in the property reserve. If the annuity payments extend beyond life expectancy a period of ineligibility for payment of nursing facility level of care may result. Sometimes annuities are being annuitized to provide very small monthly payments and include a large final balloon payment that is scheduled to be made within life expectancy but, in many cases, these final payments are made to a beneficiary named on the policy rather than to the annuitant who passes away prior to the expiration of that life expectancy. These annuities do not result in a period of ineligibility for payment of nursing facility level of care even though they do not provide equal payments since at the time of the eligibility worker’s review of the documents the payments are scheduled to exhaust within the annuitant’s life expectancy, and they are also being established as irrevocable, unassignable and nontransferable with no cash surrender value.

This leaves individuals with no means to access the cash surrender value to pay for their own care and leaves the state with no means to recover the costs of care because under current law payment must be made to the named beneficiary pursuant to the contract.

UNDER THE DEFICIT REDUCTION ACT OF 2005 (DRA)

The Deficit Reduction Act of 2005 (DRA) changed the way annuities were treated for purposes of qualifying for Medicaid.

In its capacity as single state agency charged under federal law with the administration of the Medicaid program known as Medi-Cal, the California Department of Health Care Services (DHCS) must be named as the remainder beneficiary of all annuities in which a Medi-Cal applicant or spouse has or acquires a known interest and is required to recover the costs of all medical assistance provided from any amounts remaining to be paid from annuities at the time of the annuitant’s death.

Under the DRA, Medicaid applicants are required to disclose any interest in an annuity. The DHCS must be named as the primary remainder beneficiary (or as the second remainder beneficiary after a community-based spouse or minor or disabled child) for at least the value of the medical assistance provided.

Finally, if DHCS is not named as the remainder beneficiary in the proper position, the annuity must be treated as a transfer of assets for less than fair market value (FMV) that may result in a period of ineligibility for payment of care in a nursing facility, medical institution at the nursing facility level of care and home and community-based waiver services.

The full purchase price of any annuity is to be considered a transfer of assets, not just a portion that is used to fund payments extending beyond life expectancy as is the current policy today.

Annuities purchased by or on the behalf of an individual who applied for payment of HAF care services must be treated as a transfer of assets for less than FMV unless the annuity is a retirement plan as set forth in the Internal Revenue Service Code, or unless the annuity is irrevocable, non-assignable, actuarially sound, and provides for payments in equal amounts during the term of the annuity, with no deferral and no balloon payments.
UNDER CALIFORNIA'S WELFARE AND INSTITUTIONS CODE

California took a different route to the same end than that set out under DRA.

- Under DRA, the purchase of an annuity is considered a transfer of assets unless the institutionalized individual or his or her spouse names the State as a remainder beneficiary. As such, the purchase of an annuity may be subject to transfer of asset penalties (periods of ineligibility).

- California established law (W&IC §14009.6(a)) that names the Department, by operation of law, as a remainder beneficiary in priority position of annuities purchased by an institutionalized individual or his or her spouse.

- If an institutionalized individual, his or her spouse or representative notifies DHCS in writing that he or she prohibits the state from acquiring a remainder interest in his or her annuity, the purchase price of the annuity must be treated as a transferred asset (W&IC § 14009.6(d)).

- This makes it easy for the beneficiary who will now not have to worry about how to go about making the state a remainder beneficiary to ensure that the DHCS does in fact receive any remaining amounts upon the death of the annuitant.

INFORMATIVE DIGEST/POLICY STATEMENT OVERVIEW

Medi-Cal is California's version of the federal Medicaid program that provides medical assistance to 7.5 million California residents who cannot afford to pay for their own medical care. Medi-Cal is financed in approximately equal amounts by the State of California and the Federal government.

Medi-Cal has a number of programs available to people who meet certain requirements in order to be eligible. That provide medical assistance to individuals.

- Some programs have property limits.

- Most programs have income limits to qualify and some require an individual to spend some of his or her income on his or her medical expenses each month (known as a "share of cost") before Medi-Cal will pay the remainder of the individual's medically necessary Medi-Cal covered services for that month.

- There are additional rules for those who live in nursing homes and for those who receive home and community-based waiver services.

To be eligible for Medi-Cal, an individual's countable property may not exceed the established property reserve limits for the respective Medi-Cal program. Property is defined as "real property" and "personal property."

- "Real property" is land, buildings, mobile homes which are taxed as real property, or life estates in real property.

- "Personal property" is any kind of liquid or non-liquid asset, i.e., cash, cars, jewelry, stocks, bonds, financial institution accounts, boats, trucks, trailers, promissory notes, mortgages, and deeds of trust, etc.

- Property that is not counted in determining eligibility is called "exempt" or "unavailable" property.

- Countable property (property which is not exempt or unavailable) is included in the "property reserve."

- Any amount over the property reserve limit will make the individual or the family ineligible for Medi-Cal unless spent down.

Under current Medi-Cal rules, annuities are used to spend down otherwise excess property by changing what would otherwise have been excess countable property resulting in ineligibility for Medi-Cal into countable income that does not result in ineligibility. They are used most frequently by
institutionalized individuals who do not have the ability to transfer countable property. Sometimes they are established with balloon payments used as a method to shelter funds for heirs who are paid pursuant to the annuity contract upon the death of the institutionalized individual.

The Deficit Reduction Act of 2005 (DRA) tightened Medicaid rules to discourage the use of investment annuities that are not irrevocably annuitized over a person’s life expectancy and without deferrals or balloon payments as a means to establish eligibility for HAF care services by requiring that state Medicaid agencies (DHCS in California) be remainder beneficiaries on the annuity contracts to obtain repayment for medical assistance provided to institutionalized individuals. If the state is not made a remainder beneficiary, then the purchase price of the annuity is to be considered a transfer of assets that may result in a period of ineligibility for HAF care services under Medi-Cal.

Senate Bill 483 requires an individual to disclose a description of any interest that the individual or his or her spouse has in an annuity, as a condition of eligibility for medical assistance for home and facility care services.

Additionally, as an operation of law, SB 483 requires the state to become a remainder beneficiary of certain annuities, unless the individual notifies the state in writing that he or she prohibits the state from becoming a remainder beneficiary. 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 annuity must be treated as a transfer of assets for less than fair market value for purposes of determining Medi-Cal eligibility.

The provisions of SB 483 apply prospectively from the date regulations are adopted and filed with the Secretary of State. Specifically, Section 50489.10 sets forth the treatment of annuities established after the implementation of DRA for purposes of determining Medi-Cal eligibility.

SEC. 6. Section 14009.6 is added to the Welfare and Institutions Code, to read:

14009.6. As a result of providing medical assistance for home and facility care to an individual, the state must, by operation of law, become 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 the individual or his or her spouse is an annuitant, except as provided in Section 14009.7, unless the 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, in which case subdivision (d) must apply.

This section must only apply to the following annuities:

- Those purchased on or after February 8, 2006.
- Those purchased before February 8, 2006, and subjected to a transaction that occurred on or after February 8, 2006.
  - For the purposes of this paragraph, “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.
  - For the purpose of this paragraph, “transaction” must not include any of the following:
    - 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.

Any provision in any annuity subject to this section that has the effect of restricting the right of the state to become a remainder beneficiary is void.
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 must be treated as the transfer of an asset for less than fair market value that is subject to Section 14015.

- When the state becomes aware of an annuity in which it has acquired a remainder interest, the department must notify the issuer of the annuity of the state’s acquisition of its remainder beneficiary interest.
- The issuer of the annuity must, upon notification by the department, immediately inform the department of the amount of income and principal being withdrawn from the annuity as of the date of the individual’s disclosure of the annuity.
- The issuer of the annuity must, upon request by the department or any agent of the department, immediately disclose to the department the amount of income and principal being withdrawn from the annuity.
- The issuer of the annuity must immediately notify 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.

Any moneys received by the state pursuant to this section must be deposited into the General Fund.

This act, which was approved by Governor September 27, 2008, and filed with Secretary of State September 27, 2008, amends Sections 14005, 14015, and 14018 of, amends and renumbers Section 14002 of, and adds Sections 14006.01, 14006.15, 14006.41, 14009.6, 14009.7, 14015.1, and 14015.2 to, the Welfare and Institutions Code, relating to Medi-Cal.

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, to the extent required by federal law, requires 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 requires 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 also requires 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 has 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 also expresses the intent of the Legislative that its provisions 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.

E. **Effect of annuity income on Medi-Cal threshold**

**ANNUITY INCOME AND THE MEDI-CAL THRESHOLD**

While they are in long term care people can have income of up to $35 per month - the "maintenance need standard" which the state sets. If their income is higher than that, they may qualify nonetheless if they agree to pay the medical costs each month until they reach the $35 threshold, then Medi-Cal will pay the remainder, provided the services are covered. This is known as the share of cost.

The income received from an annuity is considered “available” to pay for the costs of the recipient. It is also considered when establishing the community spouse allowance. The income from most annuities solely the name of the community spouse is not considered available to the spouse on Medi-Cal. An exception would be if the community spouse established the annuity using funds that were community property.

F. **Duty of honesty, good faith, and fair dealing; breach of duty (CIC 785)**

**GOOD FAITH AND FAIR DEALING (SECTION 785 CIC)**

In any dealings with seniors, keep in mind that all insurers, brokers, agents, and others engaged in the transaction of insurance owe a prospective insured who is 65 years of age or older, a duty of honesty, good faith, and fair dealing. This duty is in addition to any other duty, whether express or implied, that may exist.

California agents selling annuities have certain responsibilities; some are specific to seniors while others apply to all consumers.

“All insurer, brokers, agents, and others engaged in the transaction of insurance owe a prospective insured who is 65 years of age or older, a duty of honesty, good faith, and fair dealing.”

Section 785 of the California Insurance Code. Many of the provisions of Senate Bill 620 (Scott, 2003) reinforce the agent's duty of honesty, good faith and fair dealing in regard to selling annuities to seniors.
XI. THE SENIOR MARKET

The Senior Market

With more and more Americans approaching retirement, the need for individuals to take charge of, and carefully plan for, their own retirement income has never been greater. Unfortunately many preretirees are woefully unprepared for what lies ahead.

In just a few years, the leading edge of the baby boomer generation of 77 million individuals will turn 60. But will they be able to meet the challenges of “retirement readiness”—a state of financial independence where decisions are made based on choice, not economic necessity? Will this generation, which is retiring earlier and living longer in an environment of diminishing Social Security and pension plan safety nets, be able to live comfortably in a retirement which may last 20 to 30 years or longer? Today’s baby boomers can expect to live longer, healthier lives than any generation before them. While baby boomers will soon increase these figures even more, due to improvements in health care and lifestyle, the current older population itself is living longer. According to the U.S. Bureau of the Census, by the year 2030, there will be twice the number of people age 65 and older as there were in 2000. This segment, which represented almost 13% of the population in 2000, is expected to grow to 20% of the population by 2030. Since 1900, the percentage of Americans age 65 and older has more than tripled (4.1% in 1900 to 12.4% in 2000), with the actual number growing eleven times (from 3.1 million to 35.0 million). Today, a person reaching the age of 65 is likely to survive an additional 17.9 years. For decades the median age at which people expected to retire is 62. However, a recent edition of The Harris Poll indicates that this expectation decreases with the current age of workers. Those age 25 to 29 expect to retire at age 60, for example; those 18 to 24, expect to retire at age 58. The fact that aging Americans are both retiring earlier and living longer, places additional strain on the need to prepare adequately for retirement. There will be a tremendous opportunity for insurance agents to sell annuity products to this growing older population. An annuity can be appropriate as part of an overall financial plan for an older adult. There are many well-qualified and capable financial professionals who provide solid advice to their clients about annuities and other financial products. They provide complete information to clients, about advantages and disadvantages of the products they offer, in regard to the client’s individual financial position and objectives. However there are also many who prey on seniors using misinformation and scare tactics to sell annuities.

A. Market Volatility Risk tolerance and the Senior Client

MARKET VOLATILITY AND RISK TOLERANCE OF SENIORS

The life a senior today is far more complex than he ever dreamed it could be. In their younger years, for example, virtually everyone bought whole life insurance to cover burial costs and/or to build a small pot of money down the road. They started with a small whole life policy and paid on it forever. Things like long term care coverage never existed and annuities had limited application. Senior generations today live with substantially higher liability and lifetime medical limits in response to more lawsuits and escalating hospital bills. Recent market volatility has added to senior woes where up to 33% of their retirement stash has been lost. Millions are now seeking safe places to stash what is left.

These factors and more have created the need for specialized and complex products. It is your job as agent to unwind this complexity, make your product suggestions crystal clear and determine a seniors exact risk tolerance based on assets and liquidity needs. Above all, you must share the downside potential present in any financial product . . . such as annuity surrender charges . . . especially where you are replacing an existing product. Only then can a senior client make an informed decision.

Agents and seniors should understand the delicate balance between risk and reward. Riskier investments have the potential for greater returns, while conservative investments typically generate lower returns. Conservative investments do not generate high enough returns but potentially higher-yielding investments subject seniors to principal risk. In the long-term failure to achieve growth while preserving principal increases the risk of outliving assets. All investments, however, subject seniors to some type of risk.
Interest Rate Risk

Interest Rate Risk applies to most fixed interest products where the prevailing interest rate is dependent on the market value of the underlying investment. Interest rate risk is a particular threat to stocks and fixed-income investments like bonds. Rising interest rates can make stocks less appealing and cause share prices to fall. Rising rates have an even more direct effect on existing bonds, nearly always causing them to decline in value.

Credit Risk

Credit risk also affects fixed rate investments, such as bonds. Essentially, a bond is like a loan and credit risk is the risk that the issuer of a bond will default on its obligation.

Business Risk

Business Risk is the risk that the investment's value will decline due to a decline in the underlying company's value. It is the possibility that the company issuing a security may not be able to meet its financial obligations.

Market Risk

Market risk is the chance that financial markets in general may rise or fall in value. With a variable annuity, there is a risk of the underlying investments performing poorly. This risk is balanced by the potential of receiving a higher return than would be possible with a fixed return investment.

Inflation Risk

Inflation risk is one of the most important factor for long-term investors to consider especially when purchasing fixed annuities. If the return fails to keep pace or exceed the inflation rate, clients will lose purchasing power.

Risk of Outliving Assets

The biggest risk of all is the risk of outliving assets. This possibility has increased dramatically since people are living longer. Coupled with the trend for early retirement this means retirement savings must last even longer than in the past.

BALANCING RISK AND RETURN

Investors will not take on greater risks without the possibility of higher earnings. In general, the greater the risk, the higher the potential return; the lower the risk, the lower the expected return. As things in life change, such as income, age, or number of dependents, clients should reexamine their investments and rebalance them occasionally to design a strategy that is in line with their financial goals.

Agents should ask their clients which of these four categories best matches their investment attitude:

- **Conservative:**
  - Feel very uncomfortable if the value of investments dropped, even in the short term.
  - Willing to accept a lower long-term growth rate in order to reduce risk.

- **Moderately Conservative:**
  - Willing to put some money into volatile investments in the hope of achieving substantial long-term growth, but keep most of it in more stable, low-risk investments.

- **Moderately Aggressive:**
  - Want both stability and long-term growth, but with more emphasis on growth.
  - Understand that this means putting money in investments that can go up or down in value at any time.
• **Aggressive:**  
  o Priority is significant long-term growth. Willing to accept a drop in investments’ value, even for several years, in the hope of achieving greater long-term growth.

### Annuity Policy Risks

The following scale compares the risk of eight types of investments to their possible gain.

![Risk Scale Diagram](image)

**B. Pre-retirement vs. post-retirement planning**

**QUALIFIED PLANS AND ANNUITIES / DEFINED BENEFIT - DEFINED CONTRIBUTION**

Many employers allow their employees to contribute to an annuity inside their retirement plan. Under these *qualified* plans, a person’s current taxable salary is reduced and invested in a multitude of investments, including fixed or variable annuities, i.e., these annuities are purchased using *before tax dollars*. If a person owns a small business, he can also invest in a qualified annuity by setting up a Simplified Employee Pension (SEP), a Keogh or a 401k and invest the funds in annuities. Benefits from qualified plans vary widely, taking the shape of defined benefits or a percentage of the account value (defined contribution), and are subject to required minimum distributions (starting at age 70.5), which are fully taxable, as well as a 10% penalty if withdrawn before age 59.5.

*Non-qualified* or privately purchased annuities can also be used in a retirement strategy since they are generally safe, provide tax advantages when accumulating and can provide guaranteed income for a specified period of time, like a *defined benefit pension*. Or, provide a payout at retirement based on the value of the account, much like a *defined contribution plan*.

The path chosen is typically determined when the annuity owner retires and is based on their lifestyle and other revenue sources they may receive from investments, Social Security, IRAs and other qualified retirement plans from previous employers or self-employment.

Benefit amounts from non-qualified annuities are taxed on their earnings when withdrawn. The amount received is based on account balances and the client’s needs at that time. Some nonqualified annuity owners may seek the comfort of their annuity paying them a check a month for life, while others might...
decide to leave the balance intact . . . keeping it available for major emergencies . . . and withdraw interest in bits and pieces or at a set amount each month. Still others can decide that BOTH are the way to go and choose to annuitize a portion of their account while leaving the rest as an emergency fund. Indeed, annuities offer great flexibility in retirement whether in qualified or non-qualified environments.

**RETIREMENT PLANNING**

**PRE-RETIREMENT VS. POST RETIREMENT PLANNING**

*Prior to retirement* a client's goals and objectives should be assessed. This process should begin in earnest at age 40 or sooner. The underlying emphasis here is to determine the following:

- Learn about retirement plan funding methods.
- Determine an appropriate contribution level for your employee savings plan.
- Develop strategies to accumulate assets.
- Use methods to reduce taxes.
- Formulate an asset allocation strategy.
- Reviewing wills and other legal documents.

The agent's role can be the suggestion of suitable product to achieve these goals along with appropriate referrals to outside professionals where needed. Annuities with growth potential have more application at this phase.

When a client is *closer to retirement*, the planning process notches up to include the following:

- Making sure their goals are realistic.
- Repositioning their assets and benefits.
- Analyzing available retirement income funding methods.
- Identifying alternatives to continue the growth of their assets while producing income and minimizing taxes.
- Confer with a team of financial advisors.

Again, the agent enters to position or re-position appropriate and suitable product.

*Post-retirement planning* doesn't end when the client stops working. Why? Because he must continue to maximize his income, refine goals, minimize taxes and penalties for premature distributions, excess distribution and underestimated withdrawals beginning at age 70 ½, organize assets, prepare for proper estate planning, determine appropriate housing and determine and identify any major purchases to be made.

Clients will look to agents to again re-position product and refer to outside professionals in an appropriate and suitable manner. Annuity rollovers, exchanges and annuitization are typical topics of discussion.

A comfortable retirement involves making certain that retirement assets, combined with Social Security benefits, will generate income sufficient to sustain the lifestyle seniors want.

Many of today’s pre-retirees expect to retire early and live long, healthy lives. At the same time, most underestimate the amount of money they will need in retirement, and many are not saving enough to continue their current lifestyle. According to the *2002 Survey of Prospective Retirees*, 33% say they plan to live on just the interest and earnings from their investments during retirement; 29% plan to spend down their asset base. Only one in ten plans to increase assets each year. Pre-retirees need to identify their retirement objectives early on so that investment portfolios can be tailored to meet future needs. Proactively managing investments is another important consideration. Many financial experts today suggest that retirees will need between two-thirds and three-quarters of their pre-retirement income to maintain their current standard of living in retirement. This is based on the premise that spending on such items as commuting, clothing, etc. will decline when one leaves the workforce. According to the 2002
Survey of Prospective Retirees, respondents feel they need to replace, on average, 60% of their income in retirement. Just over a third (35%) feel they need to replace 70% or more of their household’s pre-retirement income to live comfortably in retirement. Pre-retirees should also have a comprehensive financial plan that addresses other financial contingencies, such as long-term care. If a senior requires long-term care, the cost could wipe out a lifetime of savings. Since long-term care is not covered under most health plans, the only way to subsidize the cost may be by liquidating retirement savings. The cost of long-term care for one spouse may require the other spouse to make changes to living arrangements or return to work. It could also mean using the assets that seniors intended to pass on to the next generation. After retirement, seniors need to make sure that funds accumulated during their working years can sustain their cost of living and retirement objectives over their remaining lifetime. This usually involves a shift in investment philosophy from emphasizing growth to a focus on safety and asset preservation. A new study, conducted by Chicago-based Aon Consulting, finds that average spending declines very little in retirement. While some costs such as shelter decrease, others, such as healthcare, actually increase. The study also finds that post-retirement spending is on the rise, while saving by active workers as a percentage of income is declining. In recent years current retirees are spending at a rate that accelerates depletion due to recent market performance. Many retirees will have to reduce their living standards or they may run out of money altogether.

Retirement readiness presents a significant challenge to individuals and the federal government. It is clear that the future well-being of a large and growing segment of our population rests on finding a way to close the gap between the current inadequate level of retirement planning the level that will be necessary for the tens of millions of individuals who will be retiring over the next decade. The financial services and insurance industry has the necessary human, technological, and financial resources to help Americans enjoy their retirement. Agents can help by promoting and stimulating increased participation in both qualified and unqualified retirement plans.

Education, information and advice will be critical in helping individuals to both accumulate sufficient funds for retirement, and transform those savings into retirement income that will last as long as they live. That’s definitely an area where annuities shine.

VARIABLES TO CONSIDER

For adequate retirement planning it is necessary to consider a number of variables that can effect savings, spending and lifestyle of the future. Agents should consider their client’s time horizon until retirement and considering the number of years left during the retirement years.

Remember, people are living longer and longer, current lifestyle and future desired lifestyle, spending money now and how to spend it in the future, resources available now and in the future including personal savings, employer benefits, social security and inheritance, if any, taxes now and later. Will tax rates go up or come down? As this issue is not predictable it is best to plan for the worst case scenario, inflation rates now and later and investment returns for your investments. Consider diversification and asset allocation for well-rounded portfolio results.

C. Financial concerns

FINANCIAL CONCERNS

Seniors have more to worry about than where travel nest or the next golf tee time. Their financial concerns are the same as anybody with the added burden that they could outlive their income by spending through their assets. The foundation of their world focuses on their financial staples: Social Security, retirement plan distributions and investing retirement assets.

A generation ago, Social Security and pensions took care of most people’s needs during retirement, which lasted an average of only twelve years. With people retiring earlier and living longer, many may spend almost as much time in retirement as they did in the work force. Traditionally the American retirement savings system has rested on three legs: Social Security, employer pensions, and personal savings. But with Social Security and conventional defined benefit pension plans predicted to play a
considerably smaller role in providing retirement income in the future, it is clear that individuals must take a more active role in providing for their own retirement security.

1. Social Security

SOCIAL SECURITY

In general, an individual is entitled to a retirement benefit if he or she:

1. is fully insured (worked an adequate number of quarters),
2. is at least age 62 throughout the first month of entitlement, and
3. has filed application for retirement benefits.

Age 62 is the earliest age that a retired worker who is fully insured can start to receive retirement benefits. The retirement age when unreduced benefits are available (presently age 65) will increase by two months a year for workers reaching age 62 in 2000-2005; will be age 66 for workers reaching age 62 in 2006-2016; will increase by two months a year for workers reaching age 62 in 2017-2022; and will be age 67 for workers reaching age 62 after 2022 (i.e. reaching age 67 in 2027).

Amount of a Retirement Benefit

A retirement benefit that starts at Normal Retirement Age equals the worker's PIA (primary insurance amount). But a worker who elects to have benefits start before Normal Retirement Age will receive a monthly benefit to only a percentage of the PIA. As a general rule, a person taking reduced retirement benefits before Normal Retirement Age will continue to receive a reduced rate after Normal Retirement Age.

You should also note that a person is entitled to retirement benefits regardless of how wealthy he is. Also, the amount of retirement income a person receives (e.g. dividends, interest, rents, etc.) is immaterial. A person is subject to loss of benefits only because of excess earnings arising from his personal services.

Survivor’s Benefits

Benefits payable to the survivors of a deceased insured worker include mother’s or father’s benefits with children, surviving spouse of an insured worker, child of a deceased worker, widow(er)’s benefits and a lump sum death benefit of $255.

Social Security Cutbacks

Social Security and Medicare is paid on a “pay as you go basis”. Unfortunately, the ratio of the working age population (ages 20-64) to the retired age population (ages 65 and over) will decline from the current level of 4.7 workers per retiree to 2.8 workers per retiree by the year 2030, when most of the baby boomers will have retired. To finance the same retirement benefits on a pay as you go basis, active participants would have to pay about 67% more in Social Security taxes in 2030.

The baby boomers probably will feel a large crunch from the reduction in Social Security and Medicare benefits. Take for example, a person who is now age 45, earning $61,200 annually, and wishing to retire at age 67. To cover a 10% reduction in Social Security benefits will require an additional $63,000 at retirement.

According to the Social Security Administration, Social Security currently protects 150 million workers with over 44 million people receiving retirement, survivor, and disability benefits.

Social Security was never intended to provide full retirement income for working Americans. Instead, it was designed to compliment other sources of retirement savings, such as pensions.
Social Security is funded by a combination of employee deductions and employer matching funds (or self-employment contributions) up to a maximum taxable earnings limit. In 2013, contributions are based on 6.20%, up to a limit of $113,700.

In general, individuals qualify for Social Security benefits by earning credits. In 2013, a credit is earned for each $1160 of income up to a maximum of four credits per year. Most currently working adults will qualify for benefits with 40 credits (10 working years). Special rules apply to access benefits for survivors and to access disability benefits provided under Social Security.

The average monthly Social Security benefits paid to current beneficiaries in 2013 is $1261 for all retired workers or $ to an aged couple with both receiving benefits. The maximum Social Security Benefit for a worker retiring at full retirement age is capped at $2,533 per month (2013).

Social Security benefits are an important income source for retirement, but they are usually not enough. No one knows what the future of Social Security will be. In fact, the Chairman of the Federal Reserve Board, Alan Greenspan, recently suggested reducing Social Security benefits for future retirees.

Social Security today replaces about 40% of the average worker’s pre-retirement earnings. For two-thirds of the elderly, it is a major source of income; for one-third, it is virtually their only income. When Social Security started in 1935, a 65-year-old had an average additional life expectancy of just over 12 years; today that figure is over 17 years and rising. By 2030, there will be almost twice as many older Americans as there were in 2000. At the same time, the number of workers paying into the system per beneficiary will shrink from 3.3 today to an expected 2.0.

Many people think Social Security tax contributions are held in interest-bearing accounts earmarked for payments to future retirees. In reality, however, Social Security is a “pay-as-you-go” system, which means taxes paid by today’s workers fund benefits for today’s retirees. Social Security is now taking in more taxes than it pays out in benefits, with excess funds credited to the Social Security’s trust fund.

Based on the intermediate projection set out in the 2002 Annual Report of the OASDI Board of Trustees, if no changes are made, the increase in benefit expenditure due to aging baby boomers will eliminate the surplus by 2017 and exhaust the trust fund’s accumulated reserves by 2041. Clearly, pre-retirees today will need to look beyond Social Security income if they are to live comfortably in retirement. In 1998, 58 percent of all households with at least one member age 65 or older depended on Social Security for 50 percent or more of their total income, and more than one in four depended on it for 90 percent or more, according to the US Dept of Labor, Pension and Welfare Benefits Administration.

| The Social Security Full-Benefit Retirement Age, 2002-2025 |
|----------------|----------------|----------------|
| Year of Birth | Year Individual Will Reach Age 65 | Full Benefit Age (Years/Months) |
| 1937 | 2002 | 65 |
| 1938 | 2003 | 65/2 |
| 1939 | 2004 | 65/4 |
| 1940 | 2005 | 65/6 |
| 1941 | 2006 | 65/8 |
| 1942 | 2007 | 65/10 |
| 1943-1954 | 2008-2019 | 66 |
| 1955 | 2020 | 66/2 |
| 1956 | 2021 | 66/4 |
| 1957 | 2022 | 66/6 |
| 1958 | 2023 | 66/8 |
| 1959 | 2024 | 66/10 |
| 1960 and later | 2025 and later | 67 |
SOCIAL SECURITY TAXATION

A portion of Social Security benefits may be subject to income taxation, depending on the recipient's tax filing status and level of "provisional income." For most people, "provisional income" is adjusted gross income, plus tax exempt income, plus one-half of their Social Security benefits.

For a married couple, filing jointly, Social Security benefits become taxable if their provisional income exceeds $32,000. Between provisional income levels of $32,000 and $44,000, up to 50% of Social Security benefits are income taxable. Above the $44,000 level, 85% of Social Security benefits are income taxable. For married persons filing separately, the 85% tier applies from the first dollar of provisional income.

For a single person, the 50% tier of Social Security benefit taxation applies between provisional income levels of $25,000 and $34,000. The 85% tier of Social Security benefit taxation applies to provisional income levels above $34,000.

Many people resent the fact that their Social Security benefits can be subject to income tax. For these individuals, annuities provide a means of avoiding such taxation. Because annuity earnings and the excluded portion of annuity payments are not included in provisional income, shifting assets from taxable investments or tax-exempt bonds can sometimes lower an individual's or a couple's provisional income sufficiently that Social Security benefits will not be subject to income taxation.

2. Retirement plan distributions

RETIREMENT PLAN DISTRIBUTIONS

Prior to age 70½ clients do not need to take money out of their retirement accounts—though your employer's plan might require them to do so. In fact, there will usually be a 10% early withdrawal penalty if they make withdrawals from an IRA before age 59½. Between the ages of 59½ and 70½ they pay only the income tax on any amounts they decide to withdraw, with no tax on the return of after-tax contributions made.

Once a person hit 70½, withdrawals must begin. Technically they can be postponed until April 1 of the year following the year they reach 70½—say April 1, 2015 if they reach 70½ in 2014. But waiting until April 1 means they must withdraw for two years—2014 and 2015—in 2015. To avoid this income bunching and a possible higher marginal tax rate, tax advisers generally suggest withdrawing in the year seniors reach 70½.

IRS has greatly simplified and relaxed the withdrawal rules, effective for 2003 and after. The thrust of the changes is to increase the retirement plan tax shelter, by lengthening, in most cases, the period over which plan withdrawals may be stretched.

The rules now allow clients to automatically spread withdrawals over a period substantially longer than their life expectancy. Under these rules the taxpayer (say, an IRA owner) first determines his or her retirement plan asset values as of the end of the preceding year. Then the owner takes the number for his or her age from an IRS table (the table is unisex). The number corresponds to the period over which the withdrawals may be spread. The owner divides that number into the retirement asset total. The result is the amount to be withdrawn for the year.

Under the current rules, the life expectancy of a designated beneficiary (if any) is irrelevant in figuring the withdrawal period (except for a beneficiary spouse more than 10 years younger).

Thus, clients can change their designated beneficiary at will, or replace one who died, without affecting the withdrawal period (except for a change to or from a spouse more than 10 years younger).
Agents can advise clients that they can always take out money faster than required—and pay tax on these withdrawals. However, the tax code is strict about minimum withdrawals. If they—or their beneficiaries or heirs—fail to take out what's required, a tax penalty will take 50% of what should have been withdrawn.

Two primary sources for retirement plan distributions are employer-sponsored plans and individual retirement plans, such as IRAs.

**ERISA (Employee Retirement Income Security Act)** requires employers to provide information about plan features and funding on an annual basis to plan participants. It also establishes standards for resolving disputes, grievances, and legal actions.

Employers must file their plan documents with the Internal Revenue Service as well as an annual tax returns detailing plan contributions and assets help ensure continued compliance.

Along with Social Security, generations in the past have relied on company pensions known as defined benefit (DB) plans for retirement. With these plans, employers typically promised a lifetime stream of income to retirees based on their cumulative earnings, years of service, and age at retirement.

In 1978 the Revenue Act of 1978 was passed permitting certain types of defined contribution (DC) plans which allow employees to defer part of their pre-tax income until retirement. These plans typically establish contribution rates by employees and employers. Retirement benefits are based on the accumulated earnings of the funds. The most common example of a defined contribution plan is the 401(k). Many employer-sponsored profit sharing plans are also structured as defined contribution plans.

Over the past 25 years, these plans have radically changed the American pension plan system by shifting responsibility for the financing and investment of retirement benefits from employers to employees. Since their introduction, 401(k) plans have come to dominate the DC portion of the private pension system.

As participation in 401(k) plans has grown, coverage in DB plans has declined. Eighty million workers participated in private sector retirement plans in 2001. Approximately 70% of the total were in DC plans; only 30% were in DB plans. In 1998, 47% of all contributions to pension plans were made by employees compared to only 11% in 1978. In real dollars, employer contributions to all types of pension plans were 18% lower in 1998 than in 1978, while employee contributions were 480% higher. The decrease in company pension plans greatly increases the burden on individuals to take charge of and carefully plan for their own retirement income needs. This is where annuities can help.

Another way of generating retirement income is from personally sponsored plans, such as IRA's, Roth IRA's or SEP plans.

### 3. Investing retirement assets

#### INVESTING RETIREMENT ASSETS

At retirement age, a senior's attention shifts to retaining principal, maximizing income and minimizing taxes. This is not the time to suggest an aggressive variable annuity with a long surrender time line because a senior may need to get at their money at any given moment for a major medical emergency or chronic illness not covered by Medicare or a health plan.

When investing retirement assets, there are several considerations that seniors should take into account.

- **Diversification** - A diverse portfolio helps reduce risk in general and assure that gains will balance losses.
- **Preservation of Capital** - The assets used to generate retirement income should be focused on preserving capital.
- **Peace of Mind** - Seniors can achieve peace of mind by using asset allocation to allocate money across different asset classes, like stocks, bonds, cash and real estate.
• **Fighting Inflation** - Since goods and services are likely to cost more in the future than they do today it is important for investments to keep up with inflation.

According to a Report on Vanguard Defined Contribution Plans: “How America Saves 2002,” less than half of all American workers were covered by employer retirement plans at the end of 2001. But even those that do participate in retirement plans, according to a recent *Washington Post* article, have saved very little. Of all the workers with 401(k) plans in 2000, 44% had balances of less than $10,000; 14% had only $10,000-$20,000.

According to the 2002 Employee Benefit Research Institute (EBRI) *Retirement Confidence Survey*, the amounts accumulated for retirement by workers as a whole are generally small. Almost half (46%) have saved less than $50,000; 15% say they have saved nothing. Fewer than 2 in 10 (17%) say they have $100,000 or more saved for retirement. While the amount accumulated generally increases with age, less than one-quarter (23%) of those ages 40-59 report having saved $100,000 or more. The majority of workers expect to spend at least 20 years in retirement, so even with $100,000 saved, they would have only $5,000 per year to spend.

**D. Insurance concerns**

**INSURANCE CONCERNS**

The needs of mature market groups is far more complex than those of younger generations. Instead of simply covering an economic loss of a breadwinner, insurance and annuities may play a critical role in a client’s planning of his estate, business, investments, retirement, tax reduction, long term care and more! For the agent, this means a working understanding is needed for a wide variety of insurance products; including how they function, their specific role in helping mature markets and various implications concerning taxation and eligibility.

| 1. Health |

**HEALTH INSURANCE**

In 1965, the **Old Age Survivors Disability and Health Insurance Act (OADHI)** created Medicare, a federal program of health insurance coverage for Americans 65 and older. Medicare is funded by payroll taxes with the current rate at 1.45% of all earnings. Like Social Security taxes, Medicare contributions are deducted from the paychecks of all working Americans and the employer matches the contribution levels. Unlike Social Security, there is no income limitation on the deduction.

**Part A** of Medicare covers inpatient care in hospitals, critical access hospitals, and skilled nursing facilities. It also covers hospice care and some home health care under certain conditions. Most older Americans qualify for Medicare Part A services once they turn age 65 with no premium.

**Part B** of Medicare covers doctors’ services and outpatient hospital care. It also covers certain physical and occupational therapy, durable equipment and some home health care. Part B is subject to an additional premium of $104.90 per month in 2013.

To supplement the gaps between Medicare and complete coverage, private insurers introduced health plans called Medicare supplements, or Medigap policies. There are 10 approved Medigap policies each providing a standard set of benefits and offered by a variety of private insurers. Not all insurers offer all 10 plans.

In 2003, major reform of Medicare was passed with the Medicare Modernization Act. This legislation incorporates a drug discount card program provided through private insurers that was implemented in June 2004 and discontinued in December 2005. In addition, a major drug coverage program was passed and was introduced in 2006. The drug coverage incorporates features and limits similar to other Parts of Medicare such as monthly premiums, deductibles, and co-payments.
The Balanced Budget Act of 1997 made several cuts in the Medicare Programs, especially in regard to home health care. The BBA also created managed care plans, referred to as Medicare Advantage options. These plans generally include most of the features of Medicare Parts A & B and Medicare supplement plans, usually along with other additional benefits. Deductibles and co-payments are reduced or eliminated for participants. Employer-sponsored health plans for retirees have been cut significantly in recent years due to skyrocketing health care costs and insurance premiums.

**Medicare**

A good portion of the agent’s discussions with clients will involve Medicare. Agents who work in the mature market must fully understand this area in order to explain benefits as well as what clients cannot expect it to cover. And, if they are offering a senior HMO as an alternative, the agent must be able to make accurate and realistic comparisons.

**Medicare hospital insurance** helps pay for medically necessary care in a Medicare-approved hospital, skilled nursing facility, and hospice. It is very important to understand the distinction that a skilled nursing facility care is not the same as custodial nursing home care.

**Skilled nursing care** is acute care, while custodial is long-term care. Most nursing homes in the United States are not skilled nursing facilities, and many skilled nursing facilities are not certified by Medicare. So in conclusion, Medicare will provide for less than 2% of a client’s long-term care health payments. Medicare will, however, provide payment for health care for individuals over the age of 65 and certain individuals under the age of 65 with significant disabilities. So, Medicare is basically a health insurance program for senior citizens. The benefits available under Medicare are similar to those under most health insurance plans in the way they lack substantial or even modest levels of long-term care.

Medicare only pays for “Skilled Care in a Nursing Home” or “Intermittent Care in a Nursing Home or at Home”. Medicare does NOT pay for intermediate or custodial care, such as that required for Alzheimer’s patients. The following table will help put this into perspective:

<table>
<thead>
<tr>
<th>BENEFIT</th>
<th>MEDICARE PAYS</th>
<th>CLIENT PAYS</th>
</tr>
</thead>
<tbody>
<tr>
<td>First 20 days</td>
<td>100% of Approved Amount</td>
<td>NOTHING</td>
</tr>
<tr>
<td>Next 80 Days</td>
<td>All but - $148.00 / Day</td>
<td>$148.00 / Day</td>
</tr>
<tr>
<td>Beyond 100 days</td>
<td>NOTHING</td>
<td>ALL COSTS</td>
</tr>
</tbody>
</table>

**Senior HMOs**

In lieu of Medicare and a Medicare supplemental policy, a popular choice is the managed care plans which are often called HMO’s or Coordinated Care Plans. Most of these plans collect a fixed monthly payment from the government, regardless of the patient’s health, and must promise to cover all patient needs that would have been paid under Medicare. To contain costs, many of these groups contract with specific health care providers and clinics to offer Medicare services. In some cases, manage care groups provide a bit more than Medicare or supplement plans as an incentive to switch. Unlimited prescriptions drugs and some respite care are a couple of examples that have been used to attract Medicare enrollees. Currently, about 15 percent of the people eligible for Medicare choose managed care plans. Congress is happy about this because the government’s monthly commitment is fixed and these private concerns are far better at cost containment than Medicare.

The concept of senior managed care is being tested in some our country on a grand scale. The primary advantage to this type of system is that it is a prepaid health care plan that promotes wellness and preventative medicine.
The predicted effects of managed care tend to offset the advantages of a more traditional comprehensive health care program. Under a managed care program, doctors are salaried, and their earnings are not affected by quantity of care. Therefore, there is no incentive to over-treat patients. As a result, waste and unneeded services are minimized. The purpose of managed care is to promote cost effectiveness of medical services.

It must be emphasized that while senior HMO’s offer a few more frills than Medicare, they do not cover long term care. Services such as nursing homes and home health care are excluded for chronic conditions.

In some cases the funding for these needed services come from the client’s own pocket. And, planning for these times can be critical. For example, selling a 75-year old, moderate income woman a deferred annuity with a surrender period of 8 years is an unsuitable sale. She will likely need some of this money to provide for medical care not covered by her HMO, Medicare or long term care provider, if any.

**Medicaid and Medi-Cal**

Medicaid is a needs based program providing of long-term care for those who qualify -- mostly the poor and indigent. Even though it provides approximately 45% of the funding for long-term care, qualifying can often be a major problem.

In general, Medicaid pays for hospital, medical, prescription drug and “medically necessary” nursing home care. The Medicaid system was originally intended to be a “safety net”. It was established to assist families in crisis and help the medically needy who lacked access to medical care. Above all, it was designed as a short-term solution for health care. Use of the system, however, has been far different than was intended. The program now has the stigma of a social welfare program providing current, ongoing and long-term health care for families and seniors alike. Combined with the rapidly aging population and the high costs associated with long-term care, it is easy to see why there is great concern.

Medicaid is a needs based program. Medicaid provides benefits only to those who demonstrate a financial need. This means that a patient cannot have more than a limited amount of cash or other available assets. States that operate their Medicaid programs this way are called Share the Cost states. Of course, there are exemptions and methods for families to restructure their assets to qualify for Medicaid benefits. This process is called spend-down. It is a complicated area, but essential to the understanding of Medicaid and long term care.

### 2. Long term care

**LONG-TERM CARE**

Tragically, many consumers have convinced themselves that Medicare, Medigap supplement policies, Medicaid or their HMO will cover long term care. They do not.

Long term care insurance buyers also need to get over their resistance to the higher cost associated with quality care. People who want quality care need to plan now. The government will simply not provide it. Private insurers can and will. Evidence is the evolution of LTC policies from an era of limited, bare bones coverage, to comprehensive plans complete with alternative care options. This is a higher quality care that comes with a higher price.

Long term care must also be evaluated in light of the LTC medical continuum. Residential care facilities and adult day care, for example, are increasingly covered in today’s policies while earlier policies restricted benefit payments to only those facilities that offered Adult Day Care.

Another example might be new generation policies that cover home care and special services, without which the insured would require institutional care. Agents need to understand how the policies they offer relate to the Continuum of Care from the standpoint of policy triggers, ADLs, mental deterioration, etc. This can only be accomplished by evaluating individual policies on a case by case basis.

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Long term care services might be needed by almost anyone. An accident or sudden serious illness could be the trigger as well as a slow progressive condition like rheumatoid arthritis, Alzheimer’s / Parkinsons or cardiovascular disease. Conditions are likely to happen at any age and gender although women seem to need them more than men for various reasons.

Long-term care services can be purchased with insurance benefits, provided by government entities or paid “out-of-pocket”. Some long-term care policies ONLY cover services in a nursing home (intermediate care and skilled care facilities). Newer and more popular plans cover home and community-based service. In some instances, the home and community-based services, which often can help a person avoid going to a nursing home, have limitations. So, be sure to read the policy carefully.

For those unable to purchase LTC insurance, planning may involve finding alternative sources like annuities, reverse mortgages, viatical settlements, etc. For some, these sources may also provide the critical income needed to buy LTC insurance. One strategy, for example involves the decision to annuitize an annuity contract and use the monthly benefit to purchase long term care insurance.

Long-term care provides medical, supportive and personal services for people who are chronically ill. Long-term care provides help with performing activities of daily living, such as bathing, dressing, toileting, eating, transferring, and continence, or protective supervision for those with cognitive impairments. Due to longer lifespans, rising costs and changes in family demography, paying and providing for long-term care has become an important issue. If not properly addressed, Long-term care could devastate retirement savings. According to statistics from the California Department of Health Services:

- The average cost of nursing home care in 2013 is $7098 per month, or approximately $85,176 per year.
- The risk of needing long-term care is 4 in 10 for people age 65 and older - that's a 40% chance. For people 85 and over the risk goes up to 60%.
- The average length of a nursing home confinement lasts 2.6 years but more than twice as many people are receiving care in their homes.

LTC under retirement health plans or other sources are extremely limited, by the type of care they cover, the length of time for which they cover care, and the amount of the benefits payable. Medicare provides very little coverage for long-term care services. While it covers some short-term nursing care which is recuperative in nature. Medicare was never designed to address the long-term needs for personal and custodial care and supervision. Assistance for long-term care services is available from Medicaid, a welfare program which is jointly funded by state and federal funds. Called Medi-Cal in California, it will cover certain long-term care services for individuals with very limited assets and income. However, Medi-Cal provides no payment for assisted living and very little for home care.

Private insurance is available to cover long-term care services in a variety of different service settings. Under the Health Insurance Portability and Accountability Act of 1996 (HIPAA), benefits of a tax-qualified insurance contract will not be taxed and premiums may be deductible. HIPAA standardized benefit triggers, added consumer-marketing protections, and incorporated provisions that require services to be long-term in nature, or certified to be necessary for a period of ninety days or longer. The most popular long-term care insurance plans offer coverage up to a daily or monthly maximum benefit in a variety of service settings, including nursing facilities assisted living facilities (residential care facilities) and home and community care. Many consumers prefer comprehensive policies that offer a pool of benefit dollars that can be used for care across the entire long-term care continuum. Benefits may be subject to a lifetime dollar maximum, as well as a maximum per day, week or month for services. Lifetime (unlimited) benefits may also be available.

Inflation coverage is an important element for insuring that benefit levels keep pace with rising costs. The most common inflation feature is an automatic 5% compounded annual escalator. Premium features include spousal or partner discounts, and the option of accelerated payment features. Insurance agents need to address the potential financial devastation that can result from long-term care needs with their clients. Before clients tie-up money in an annuity with a surrender charge they must be sure they will not...
need that money for long-term care expenses. Long-term care riders can sometimes be used to this exposure, particularly if the senior does not qualify to purchase traditional LTC insurance.

<table>
<thead>
<tr>
<th>Risk of Needing Long-Term Care</th>
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<tbody>
<tr>
<td><strong>Nursing Home Care</strong></td>
</tr>
<tr>
<td>&lt;65</td>
</tr>
<tr>
<td>65-74</td>
</tr>
<tr>
<td>75-84</td>
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<tr>
<td>85+</td>
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<table>
<thead>
<tr>
<th><strong>Home Health Care</strong></th>
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<tbody>
<tr>
<td>45-64</td>
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<tr>
<td>65-74</td>
</tr>
<tr>
<td>75-84</td>
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<td>85+</td>
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</tbody>
</table>

3. **Estate planning**

**ESTATE PLANNING**

Estate planning involves the orderly process of transferring wealth from one generation to another with as little loss due to taxes, probate and other costs as possible so that the maximum amount is passed on per the deceased’s wishes. A good estate plan must be reviewed and updated as life situations change. If a premature death should occur, the accumulating funds within the annuity may be transferred to named beneficiaries, avoiding the expense, delay, frustration and publicity of the probate process. Like most assets, the annuity is part of the taxable estate, but since they pass to beneficiaries without probate, the money is available to them almost immediately after death.

An important part of estate and financial planning is dealing with disability or incapacity. Durable powers of attorney, medical powers of attorney, living wills and health care directives should be drawn-up by competent legal professionals so that the senior’s wishes can be carried out even if they are mentally or physically unable to do so themselves. Another important element of estate planning is to address whether the estate will be subject to estate taxation. If it is anticipated that the estate will be taxable, it may be possible to establish trusts or charitable giving arrangements that will minimize the taxes paid on the estate, often through the use of annuities. Life Insurance riders can also help by providing funds to pay estate taxes.

For now, it is important you know that estate planning is a two-phase undertaking. It seeks to maximize, for the estate owner and his or her family, the security and enjoyment flowing from property ownership, both during lifetime and after death.

Insurance and annuities can play an important role in guaranteeing that cash will be available at death to meet the financial costs of death. The use of life insurance to meet estate liabilities may prevent the forced sale of prime assets. This will reduce the ultimate shrinkage in estate values and protect a source of income for the beneficiaries of the decedent.

**E. Selling to the senior market**

**SELLING TO THE SENIOR MARKET**

The ability to make unlimited contributions is one reason annuities are especially appealing for late-start investors, people who waited until their 40s or 50s to start saving for retirement.
Unlimited contributions give late-starters a chance to catch up with their early planning peers. And because you can contribute to an annuity without having a current earned income, stay-at-home parents or people who have already retired can buy and add money to annuities.

Annuities are relatively safe investments. While they are not covered by federal deposit insurance, the principal and interest an individual invests in a fixed annuity contract are protected by the rigid state and federal regulations that govern insurance companies’ operations. Yet, these regulations do not protect an investor from all potential problems. If the insurance company that sold an annuity to an individual experiences severe business problems and becomes insolvent, other insurance companies doing business in the same state will be required to help meet that company’s remaining obligations.

Also, while the dollars that an individual invests in and earns through an annuity are relatively safe, the annuitant is not protected from purchasing power risk. The fixed income received from an annuity loses its value in times of inflation. For example, while a monthly income of $1,000 may sound adequate to an individual in 1990, that amount may seem trivial in 2010 if inflation has greatly increased the cost of living.

Since many investors purchase annuities to provide for living expenses during their retirement, the possibility of decreased purchasing power is an important consideration. The offset to this is the ability to buy variable and indexed annuities where investor money has the potential to grow tax-deferred in the investment subaccounts chosen or along with a pre-determined index. As with many financial options, there are risks here, such as fluctuations in principal and possible loss in value.

Annuities are relatively liquid investments because they provide ways for individuals to surrender their contracts and withdraw their funds during the accumulation period. They are not completely liquid, however, because investors may not receive the full amount that they have paid in as premiums if they decide to withdraw from their annuities. The amount that an individual would lose depends on the surrender fees and penalties assessed by the insurance company. These charges are described in the annuity contract.

Interest earnings on annuities have attracted many current investors. Rates in the last few years have been competitive, generally paying somewhat more than typical CDs. Guarantee periods vary with different insurance companies. Some will pay an initial rate for one or two years, followed by subsequent annual guarantees. Others will peg their rates to formulas based on treasury bill or consumer price indexes.

Consumer attitudes about annuities are not simply shaped by rates and terms. To some extent people are influenced by who is selling them. In the mid-1980’s, banks began to promote and market annuities. It worked! The WWII generation had lots of money in banks and trusted them.

The downside of the equation is the fact that consumers can be easily convinced to buy the wrong kind of annuity or buy too many annuities without consideration for needed liquidity at retirement. In addition there are many scam operations that often misrepresent the disadvantages of seniors' current investments and the advantages of the investments they are selling. They may even make seniors believe their bank accounts are less safe than the annuities or other investments they want seniors to buy.

In their solicitations, some of these sales agents often pose as expert financial or estate planners. They pass themselves off as a “trust advisor”, “senior estate planner”, or “paralegal”, and schedule an initial appointment with seniors in their homes. Under the guise of helping set up or update a living trust, the sales agents find out about seniors' financial assets and investments. They often work in assisted living centers, churches and other places where seniors gather, hooking elderly victims through free seminars and other sales presentations.

Senior abuse in the selling of annuities is the reason for recent legislation and the reason you are now required to take this course. The hope is that education such as this will prevent additional legislation so that you can be productive and understanding in the valuable role annuities can play in a consumer's retirement planning.
The California Attorney General recently cracked down on one company that was selling living trusts to older adults in California. According to the Attorney General's Office, the company would find out all about an older adult's finances and investments as part of the living trust planning process. Then the older adult would be approached to buy annuities after selling or exchanging existing investments. Over $200 million of annuities were sold this way.

The Attorney General reached, a settlement under which the company agreed to:

- Pay restitution and a penalty, totaling $1.1 million;
- Properly represent its purpose for contacting customers;
- Stop selling and preparing living trusts;
- Stop advising individuals to reinvest their money without addressing the potential risks; and
- Only disclose confidential information with the permission of the customer.

1. Product complexity

PRODUCT COMPLEXITY

One of the most difficult issues in selling insurance products to the senior market is the amount of knowledge that is required by agents. There are many misconceptions about how federal programs such as Medicare and Medicaid operate. Retirement funds may be derived from numerous sources including Social Security, private pensions, employer sponsored plans, and personal savings. Each source may have its own features and options. Many different income tax regulations may apply.

Private insurance policies for life insurance, long-term care insurance, and health benefits provide many different options for seniors to consider. In the annuity market there are many differences between fixed, equity-indexed and variable annuities, each with its own unique provisions and levels of risk. In addition, insurers are continually developing products with new benefits and provisions. Product differences make it difficult for seniors to accurately compare one product to another. It is important for agents to spend adequate time educating seniors on the options available.

RECORDING MEETINGS OR PRESENTATIONS

By having an audio or visual record of the meeting, agents eliminate the possibility for misunderstandings. People often hear what they want to hear, and even in the best circumstances we tend to have different recollections of events and meetings. This may be the case when discussing risk and reward, since sometimes the client only remembers the conversation about potential reward, not the possibility of loss. This type of record may also be helpful in determining a case of intermittent capacity.

An Objective, Third-Party Observer It may be feasible to include an observer in a meeting with the client’s prior permission. This should not be someone working for the agent, or anyone who could possibly be considered partial. The family CPA or attorney may be a good choice. Many times a client may be feeling uncomfortable themselves, even though they are not ready to admit it, and request to bring one of their adult children to a meeting. This can be an ideal situation for the agent since they have the opportunity to become more familiar with the extended family situation.
2. Surrender charges

SURRENDER CHARGES

Many annuities carry high surrender charges during the initial years of the contract in order to withdraw money. Usually, there is a fee charged if the purchaser surrenders their annuity within the first seven to ten years of owning it. Seniors may need their money before that time for retirement or healthcare expenses and could lose substantial amounts of money due to these charges.

3. The issue of buyer competence

THE ISSUE OF BUYER COMPETENCE

Given the complexity of insurance products it is not hard to see why untrained consumers find them hard to understand. In fact, a U.S. House of Representatives investigation into insurance regulation years ago found serious defects:

- Purchasers do not understand how limited the coverage purchased is.
- Policies seem to be drafted more with an intention of limiting claims than to restricting claims to valid circumstances.
- Policies reflect illusionary benefits.
- Sales presentations are poor in quality and misleading.
- Sales are made to persons who cannot afford to keep the policies in force for more than a few years.
- There is an absence of non-forfeiture values and consequent loss of benefits by most purchasers.
- Policies are marketing with fixed benefits and rising premiums.
- There is inadequate and misleading information about inflation protection.
- There is inappropriate taxation by the federal government
- There is inadequate technical information on solvency standards

When it comes to seniors, the complexity of insurance and annuities takes on new meaning where a senior's judgment and mental competence is often reduced or impaired.

Symptoms you should be aware of include problems remembering recent events, difficulty in following simple directions, lack of short term memory, confusion, personality changes, difficulty in finding words or finishing thoughts, disorientation of time and place, inappropriate dress or hygiene, etc.

Recognition of these signs could mean the person you are dealing with does not have the capacity to make an informed and reasonable decision about his financial well-being. It would be ethically wrong to sell to this person. In California, there could also be legal implications since a person entirely without understanding has no power to make a contract of any kind.

Although insurance agents cannot be expected to diagnose mental or cognitive impairment, agents who work in the senior market should always be alert to issues regarding the competency of the client. Common sense tells us it is unethical to sell complex insurance products to a person who is unable to understand them. It is also against the law. Unfortunately some agents have used aggressive sales tactics to get seniors to liquidate assets into annuities. In some cases, there were even allegations that some clients suffered from Parkinson's or Alzheimer's disease. There have even been reports of agents refusing to leave a senior's home until they bought a policy! Under the California Insurance Code, agents owe seniors a duty of honesty, good faith, and fair dealings. However, if all agents adhered to the code there would be no need for this course. The State of California, through the Department Of Insurance, the HICAP program, the Dept. of Aging and other regulatory bodies work diligently to see that seniors are protected.
The recognition of indicators that a prospective insured may lack the short-term memory or judgment to knowingly purchase an insurance product

Some of the warning signs of cognitive impairment are:

- The home environment is in disarray
- The person’s appearance is untidy or disheveled
- Another family member seems to be making all of the decisions for the client
- The person is unable to remember facts or locate information
- The person forgets appointments or to return phone calls

While an insurance agent is not expected to be able to assess the cognitive function of a senior, the Department Of Insurance expects agents to understand that any person of unsound mind is legally restricted from entering into an insurance contract. Not only is this addressed in the California Insurance Code, but also in the California Civil Code, which states...

When are there rescissions of a contract based on mental incompetence (Section 38 and 39 of the California Civil Code)

California Civil Code § 38 and 39

Further, any contract made is subject to rescission. (Civil Code 38 and 39)

Agents need to be even more vigilant and responsible for recognizing indicators existing with their clients and consumers that may demonstrate a lack of short-term memory or judgment.

“A person entirely without understanding has no power to make a contract of any kind but this person is liable for the reasonable value of things furnished to the person necessary for the support of the person or person’s family.” Section 38, California Civil Code

“A conveyance or other contract of a person of unsound mind, but not entirely without understanding, made before the incapacity of the person has been, judicially determined, is subject to rescission, as provided in Chapter 2 of Title 5 or Part 2 or Division 3.

A rebuttable presumption affecting the burden of proof that a person is of unsound mind must exist for the purpose of this section if the person is substantially unable to manage his or her own financial resources or resist fraud or undue influence. Substantial inability may not be proved solely by isolated incidents of negligence or improvidence.” Section 39, California Civil Code

Family involvement / power of attorney

FAMILY INVOLVEMENT / POWER OF ATTORNEY

It is very important to include the client’s family and possibly their lawyer and/or financial planner in these discussions. If there is any possibility that the proposed purchaser is not of sound mind, their family or other close advisors will know this and the person may have already given a trusted family member a power of attorney to handle their financial affairs.

Consider additional family involvement from children, brothers, sisters, etc. in making annuity investment decisions. A properly executed power of attorney is also advised. Of course, such a power must have been executed prior to any loss of competence in order to be valid.

A financial power of attorney (also known as a general durable power of attorney) is a document, created pursuant to state and federal law, which gives financial authority for a family member to act on behalf of an individual for a period of time or at a certain time.
The following kinds of financial powers of attorney:

- Limited power of attorney
- Stand alone financial power of attorney
- Financial power of attorney (in conjunction with a trust and a pour over will)

4. Unique ethics and compliance issues

UNIQUE ETHICS AND COMPLIANCE ISSUES

According to a report in Science News, approximately 6 million elderly people were afflicted with mental disorders in 1990. Many of those suffered from and were at high risk of depression and dementia. According to another report as many as 25 percent suffer clinical depression at any given time. Even more troubling are the many elderly people who suffer from dementia. "Defined as chronic degenerative diseases involving progressive deterioration of all intellectual functions, forms of dementia affect as many as 20 percent of the over-80 population in the general community and 70 percent of nursing home residents.... The two most common dementias are Alzheimer’s, a general deterioration of the brain, and multi-infarct dementia, which involves death of brain tissue as a result of a stroke." According to The San Francisco Chronicle, experts predict that by the year 2030 the number of people over age 65 with psychiatric disorders will reach 15 million. Given those facts, the question of how agents should react to clients who suffer diminished capacity becomes quite important. Special responsibilities arise when the client seems to be suffering from some mental incompetence.

5. Suitability for the senior market

CALIFORNIA ENACTS NEW ANNUITY SALES PROTECTIONS FOR SENIORS

The going is getting tougher for insurance agents who use high pressure or misleading tactics to sell annuities or life insurance to seniors. Since January 1, 2004, agents in California have faced new restrictions in the ways they market these products to older individuals, these restrictions prompted by legislators' concerns that annuities and life insurance are sometimes sold to seniors using deceptive or arm-twisting methods. Under the law, a "senior" is a person age 60 or older, although many provisions apply to those 65 or older.

The new restrictions and other changes in California's insurance code are the result of Senate Bills 620 and 618, signed into law in September 2003. Both bills were sponsored by Senator Jack Scott (D-Pasadena). According to Alison Merrilees, a consultant to Senator Scott who helped shepherd the bills through the legislative process, "The majority of insurance agents are honest, but there is also a significant minority willing to take advantage of seniors. The senators heard testimony in committee about some of these abuses, including stories of agents who would not leave a senior's home until the senior agreed to purchase a product." Senate Bill 620 sets new standards for selling annuities to seniors. Senate Bill 618 enforces these new standards with stiffer penalties. Some provisions of SB 620 were already in effect while the remaining provisions took effect January 1, 2005.

Both Bills apply to all life agents (resident and non-resident) who sell annuities to California seniors. Failure to comply with the State's new regulations could result in agents not being able to sell annuities as well as fines, penalties & loss of their insurance license.

SENATE BILL 620 (SCOTT, CHAPTER 547, 2003)

The California Department of Insurance wants to be certain that seniors are treated fairly when considering the purchase of annuities. Senate Bill 620 affects the sale of annuities to seniors by:

- Creating new annuity training requirements;
- Imposing restrictions on advertising practices;
- Imposing restrictions & disclosures when making in home presentations;
- Imposing new replacement standards;
- Developing guidelines to regulate the sale of annuities specific to Medi-Cal eligibility;
- Imposing restrictions on how funds are to be invested in variable annuities during the free-look period;
- Imposing restrictions on commission payouts to active members of the State Bar of California

The new legislation applies to all life agents who sell annuities to California consumers. In the case of the new training requirements, only non-resident direct response providers are exempt, provided they meet the State's definitions as set forth by Section 1749.8 of the California Insurance Code.

Under SB 620, a senior is defined as any person aged 60 and older, unless otherwise noted in the Bill. Some items apply to persons age 60 and older while other provisions apply to persons 65 and older.

**IN-HOME SOLICITATIONS (CIC 789.10, SB620)**

In-home solicitations have been the source of senior abuse for years. Now there is specific legislative criteria that addresses this area of annuity sales.

Any person who meets with a senior (anyone age 65 or older) 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.

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**:

**IN-HOME PRESENTATIONS (Section 789.10 of CIC)**

**EFFECTIVE JANUARY 1, 2004 Applies To Seniors Aged 60 and Older**

**WRITTEN DISCLOSURE**

A new disclosure must be delivered prior to meeting in a senior's home which may lead to an annuity sale or sales presentation. The notice must be delivered in writing no less than 24-hours prior to the meeting.

If the senior is already a client and requests a meeting the same day, notice must still be furnished before the meeting begins. The new disclosure notifies the senior of their rights, provides information about the attendees, and communicates the type of insurance sales presentation that will be made.

### In-Home Solicitation Form

(1) 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): ________________.

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

(3) You have the right to end the meeting at any time.

(4) 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)

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

In addition to the written disclosure, the agent is also required to follow new guidelines upon arriving in the senior's home. Besides a greeting, three verbal disclosures must be provided before proceeding. These include:

- The meeting's purpose is to discuss insurance; and
- The name and titles of all persons in attendance; and
- The name of the insurer represented, if known

...a business card (or other written identification) including name, business address, telephone number and insurance license number. If for any reason, the agent is asked to leave the senior's home, the agent and all attendees must do so without hesitation, immediately.

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, i.e. you cannot misrepresent the true content of the meeting, or to gather information for a follow-up visit to sell insurance, if that is the case, and state all of the following information:

(1) The name and titles of all persons arriving at the senior's home.

(2) 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.

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 1725.5 OF THE CIC:

For purposes of Sections 32.5, 1625, 1626, 1724.5, 1758.1, 1765, 1800, 14020, 14021, and 15006, every licensee must prominently affix, type, or cause to be printed on business cards, written price quotations for insurance products, and print advertisements distributed exclusively in this state for insurance products its license number in type the same size as any indicated telephone number, address, or fax number. If the licensee maintains more than one organization license, one of the organization license numbers is sufficient for compliance with this section.

Effective January 1, 2005, for purposes of Sections 32.5, 1625, 1626, 1724.5, 1758.1, 1765, 1800, 14020, 14021, and 15006, every licensee must prominently affix, type, or cause to be printed on business cards, written price quotations for insurance products, and print advertisements, distributed in this state for insurance products, the word "Insurance" in type size no smaller than the largest indicated telephone number.

In the case of transactors, or agent and broker licensees, who are classified for licensing purposes as solicitors, working as exclusive employees of motor clubs, organizational licensee numbers must be used.

Any person in violation of this section will be subject to a fine levied by the commissioner in the amount of two hundred dollars ($200) for the first offense, five hundred dollars ($500) for the second offense, and one thousand dollars ($1,000) for the third and subsequent offenses.
XII. PENALTIES (SECTION 782, 789.3, 1738.5, 10509.910 ET SEQ. OF THE CIC) 2%

| 1. Violation of provisions in Section 780 or 781 of the CIC (Section 782 of the CIC) |

**MISREPRESENTATION - CIC.782 – VIOLATION OF PROVISIONS IN CIC 780 or 781**

**780.** An insurer or officer or agent thereof, or an insurance broker or solicitor must 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:

- 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 thereunder.
- The future dividends payable thereunder.

**781.** A person must not make any statement that is known, or should have been known, to be a misrepresentation

- 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
- 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.

A person must 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.

Any person, agent, broker, or solicitor violating these above provisions of Sections 780 or 781 is guilty of a misdemeanor and punishable by a fine not exceeding one thousand five hundred dollars ($1,500) or by imprisonment not exceeding six months. CIC.782

Any insurance agent, broker, or solicitor who knowingly violates any provisions of the above Sections 780 or 781 are subject, after a hearing, to suspension of their license for a period not exceeding three years. CIC.783

| 2. Administrative penalty, amounts, rescission of contracts (Section 789.3 of the CIC) |

If an insurer knowingly violates any provision of the above Sections 780 or 781, or knowingly permits any officer, agent, or employee so to do, the commissioner, may suspend the insurer's certificate of authority to do the class of insurance in respect to which the violation occurred. CIC.783.5

**789.3.** 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.

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.

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If the commissioner brings an action against a licensee 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.

Any insurer who violates this article is liable for an administrative penalty of ten thousand dollars ($10,000) for the first violation.

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.

The commissioner may require rescission of any contract found to have been marketed, offered, or issued in violation of this article.

3. Allegations of misconduct against a person 65 year or over (Section 1738.5 of the CIC)

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 must 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:

- 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.
- Lack of notice of hearing as provided in Section 11509 of the Government Code.
- 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 must not be good cause for continuance to the extent that the unamended portion of the pleadings is ready to be heard.
- 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.
- The substitution of the representative or attorney of a party upon showing that the substitution is required.
- 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.
- The unavailability of a party, a representative or attorney of a party, or a material witness due to an unavoidable emergency.
- Failure by a party to comply with a timely discovery request if the continuance request is made by the party who requested the discovery.

4. Administrative penalties (Section 10509.9 of the CIC)

SECTION 10509.9 ADMINISTRATIVE PENALTIES:

ADMINISTRATIVE PENALTIES (CIC 782, 789.3, 1738.5, 10509.9)—SEE ATTACHMENT III

The seriousness of the new legislation is also underscored in the penalties assessed for violations:

MISREPRESENTATION OF POLICY TERMS OR BENEFITS (SECTION 780, 781, 782, 789.3 CIC)
Misrepresentation of policy terms, benefits, privileges, dividends; or to induce someone to buy one policy then sell another; or to mislead someone to forfeit his policy based on a false comparison is a crime and punishable by a fine not exceeding $25,000 or 3 times the amount lost by the victim and / or by imprisonment not exceeding one year. The commissioner may also require rescission of any contract found to have been marketed, offered, or issued in violation of this article.

**DUPLICATE, UNNECESSARY COVERAGE / DECEPTIVE ADVERTISING (1738.5, 10509.9 CIC)**

Seniors who are abused via inaccurate, duplicated or unnecessary coverage. Or, who are deceived by an agent representing himself to be someone he is not will results in still penalties, including an administrative penalty of no less than five thousand dollars ($5,000) for the first violation; $5,000 to $50,000 for a second violation. If the Commissioner at anytime believes the agent can be reasonably expected to cause harm to seniors, his license may be suspended.

Further violations for the same offense can result in another $10,000 fine for the agent and form $30,000 to $300,000 for the insurer. Further, based on the outcome of a hearing, the agent's license could be suspended or revoked.

**FAILURE TO REFUND A CONTRACT REFUND TO A SENIOR**

Seniors (age 60 and older) are now entitled to a 30-day free look and a total refund of their premiums. Insurers that fail to make these refunds in a timely manner will pay the applicant interest from the date the insurer or entity received the returned policy or certificate.

**INFORMED DECISION / REASONABLE REPLACEMENTS**

Annuity buyers are entitled to information to make an informed decision and the reasonable expectation that the consequences of a replacement of their existing policy is made. Agents not providing this are subject to an administrative penalty of no less than one thousand dollars ($1,000) for the first violation; $5,000 to $50,000 for a second violation. If the Commissioner at anytime believes the agent can be reasonably expected to cause harm to seniors, his license may be suspended. Further violation can result in another $10,000 fine for the agent and form $30,000 to $300,000 for the insurer. Further, based on the outcome of a hearing, the agent's license could be suspended or revoked.

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.

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.

Any insurer who violates this article is liable for an administrative penalty of ten thousand dollars ($10,000) for the first violation.

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.

**HEARING**

Any allegations of misconduct perpetrated against a person age 65 or over shall result in a hearing to be held within 90 days after receipt by the department of the notice. Based on the outcome of a hearing, the agent's license could be suspended or revoked.
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.

Nothing in this section must be deemed to affect any other authority provided by law to the commissioner.
XIII ROLE OF THE CALIFORNIA LIFE AND HEALTH INSURANCE GUARANTEE ASSOCIATION IN RELATIONSHIP TO ANNUITIES (Section 1067 of the CIC) 2%

USING THE CALIFORNIA LIFE & HEALTH INSURANCE GUARANTEE ASSOCIATION TO MAKE SALES (SECTION 1067.17) (SECTION 1063 OF THE CIC)

California does not allow disclosure of guaranty fund information to potential contract owners because they do not want insurers and producers to rely on the funds and their guarantees when designing and marketing products.

Each of the 50 states has enacted legislation to protect the contract owners of that state should an insurance company be faced with insolvency. State guaranty funds assess their admitted insurers an extra charge to cover any carrier insolvencies within the states. If an insurance company does become insolvent, guaranty funds help make up the difference between the assets a company has left and the amounts it owes to its annuity contract holders and other policyowners, up to certain limits. Unlike the deposit insurance on bank and savings and loan accounts, guaranty funds are funded by the insurance industry itself and not from tax dollars.

In California, the entity providing this protection is called the **California Life and Health Insurance Guarantee Association.**

This Association includes all of the insurance companies licensed to sell life and health insurance or annuities in the state of California. In essence, a pool of funds is created for the purpose of protecting any one insurance company in the event of insolvency. In order to be eligible for coverage under the Guarantee Association Act in California, a policy holder must be a resident of California.

In the event that an insurance company fails to meet its obligation to policyholders, the limits of liability for the California Life and Health Association Act as they apply to annuities are as follows:

- The association may be liable for 80% of the present value of the annuity contract,
- up to a maximum of $100,000 per insurance company, with no combined benefits being higher than $250,000 for multiple annuity contracts with multiple carriers, or combined with any life insurance benefits,
- In the event that a policyholder has multiple contracts with one insurer with values exceeding the limit of $100,000, there will be no coverage beyond $100,000,
- For married couples, however the limit applies separately.
- The Association reserves the right the reduce interest rates that were promised by the former insurance company, further reducing ultimate recovery amounts.

In the event that an insurance company becomes insolvent and the Guaranty association is required to act and may freeze the insurer’s assets and prevent policyholders from surrendering policies or withdrawing funds.

Agents are forbidden from using the Guaranty Association as an inducement to purchase annuities or insurance. Consumers are responsible to do their due diligence prior to purchasing an annuity. An annuity contract is between the policyholder and the insurer. Guarantee associations, whether in California or any other state, were created to be the last resort.

In California, as well as in other states, agents are prohibited from using the Guarantee Association in a sales presentation: "No person, including an insurer, agent, or affiliate of an insurer must make, publish, disseminate, circulate, or place before the public any advertisement, announcement, or statement, written or oral, which uses the existence of the California Life and Health Insurance Guarantee Association for the purpose of sales, solicitation, or inducement to purchase any form of insurance covered by the California Life and Health Insurance Guarantee Association."

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Attachments

I. ATTACHMENT I, ANNUITY LEGISLATIVE HISTORY - PROVIDER REFERENCE

II. ATTACHMENT II, LIFE AGENT DISCLOSURE REQUIREMENTS (SECTION 789.8 OF THE CIC)

III. ATTACHMENT III - PENALTIES
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.
- 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.
- 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.
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:

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**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 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 $92,760 + $2,000 (for 2004).

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 $92,760 + $2,000 (for 2004) in countable resources. The order also may allow the at-home spouse to retain more than $2319 (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 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 take 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
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 $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 $92,760 +
$2,000 (for 2004).

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 $92,760 + $2,000 (for 2004) in countable resources. The order also may allow the at-home spouse
to retain more than $2319 (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.

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

Dated: _________________________________________

Signature: ________________________________________

Signature: ________________________________________
Penalties Defined (Section 782, 786, 789.3, 1738.5, 10509.910 et seq. of the CIC)

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<thead>
<tr>
<th>California Insurance Code</th>
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<tr>
<td><strong>Section 782</strong>&lt;br&gt;Establishes penalties for violation of section 780 and section 781</td>
<td>Section 780 - Prohibited Misrepresentation&lt;br&gt;Section 781 - Twisting&lt;br&gt;(see page 3 for actual language)</td>
<td>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&lt;br&gt;Restitution to victim pursuant to Section 1202.4 of the Penal Code shall be satisfied before any fine imposed by this section is collected</td>
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<td><strong>Section 786</strong>&lt;br&gt;Provides for an examination period of 30 days after the receipt of the policy or certificate for purposes of review of the contract</td>
<td>no violations or penalties cited in this section&lt;br&gt;(see page 3 for actual language)</td>
<td></td>
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<td><strong>Section 789.3</strong>&lt;br&gt;Administrative penalties; amounts; rescission of contracts</td>
<td>Section 789.3:&lt;br&gt;(a) and (b) by broker, agent, or other person engaged in the transactions of insurance other than an insurer&lt;br&gt;(see page 4 for actual language)&lt;br&gt;(d) and (e) by insurer</td>
<td>789.3(a) minimum $1,000 for the first violation&lt;br&gt;789.3(b) minimum $5,000 and no more than $50,000 each subsequent violation&lt;br&gt;789.3(c) Commissioner may suspend or revoke license&lt;br&gt;789.3(d) $10,000 for the first violation&lt;br&gt;789.3(e) minimum $30,000 and no more than $300,000 each violation thereafter&lt;br&gt;789.3(f) Commissioner may require rescission of contract</td>
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<tr>
<td>Section 1668.1</td>
<td>Acts that constitute cause to suspend or revoke any permanent license issued pursuant to this chapter</td>
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<td><strong>Section 10509.9:</strong></td>
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<td>(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)</td>
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<td></td>
<td>(c) and (d) by insurer (see page 6 for actual language)</td>
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<td>(e) by person or entity after a hearing (see page 6 for actual language)</td>
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<td>10509.9 (e) the Commissioner may suspend or revoke the license</td>
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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 will take 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 thereunder.
(c) The future dividends payable thereunder.

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 therefor 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 insurer's, 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.