

Equity-Indexed Annuity

- What is an equity-indexed annuity?
- When should you buy an equity-indexed annuity?
- What are the strengths of equity-indexed annuities?
- What are the tradeoffs to equity-indexed annuities?
- What are the tax implications of equity-indexed annuities?

What is an equity-indexed annuity?

New type of annuity

An equity-indexed annuity (sometimes abbreviated as "EIA") is a new type of annuity that has been developed by life insurance companies in the past few years. (Each life insurance company that issues this type of annuity may have its own individual name for the product, but it is generally known as an equity-indexed annuity.) This annuity is called an equity-indexed annuity because the earnings on the annuity are linked to the performance of an equity index. Most life insurance companies link the interest paid on the annuity to the S & P 500 equity index. Some insurance companies may, however, use a different stock market index as the performance link for the annuity.

Equity-indexed annuities usually offer minimum interest rate guarantee

In addition to linking the performance of the annuity to a stock market index, most issuers of equity-indexed annuities also guarantee that a minimum rate of interest will be paid on the annuity if the performance of the equity index should fall below a certain level. In a sense, this type of annuity is a hybrid of a variable annuity and a traditional fixed annuity. An equity-indexed annuity gives you the right to participate in stock market gains while still offering you the guarantee that you will earn at least a minimum rate of return on the annuity. Unlike a variable annuity, whereby you assume the full investment risk (if your subaccounts perform poorly), the value of the equity-indexed annuity will not fall below a predetermined and guaranteed floor.

However, it's important to note that you can still lose money with an equity-indexed annuity. While annuity issuers may guarantee a minimum annual interest rate, they typically guarantee only 90 percent of the premiums you pay. Thus, if you do not receive any index-linked interest, which may occur if the index declines, you may lose money on your investment.

You may also lose money if you surrender your annuity before maturity. The annuity issuer may not pay any index-linked interest that has been earned if you surrender your annuity too early.

Caution: Generally, equity-indexed annuities are not registered with the Securities and Exchange Commission (SEC) and sales of equity-indexed annuities are not regulated by the SEC or the National Association of Securities Dealers (NASD). Consequently, equity-indexed annuities are not subject to rules regarding disclosures, sales practices, and customer suitability as variable annuities are.

Caution: Guarantees are subject to the claims-paying ability of the annuity issuer.

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When should you buy an equity-indexed annuity?

Want potential of stock market gains along with downside protection

The main reason for purchasing an equity-indexed annuity is to take advantage of the potential gains from the equity markets but still have some downside protection not afforded with a variable annuity. As noted, issuers of equity-indexed annuities will usually guarantee that a minimum rate of interest will be paid on the annuity if the performance of the equity index falls below a certain level for a stated period of time. Many issuers, for example, will pay a minimum annual interest rate of 3 percent on the annuity. Thus, even if the underlying equity index falls 15 percent in a year, the issuer will still credit interest of 3 percent on your annuity account. An equity-indexed annuity may be an especially good investment for an individual who is somewhat risk-averse but would at least like to have the potential of above-average gains.

Example(s): You have always been a very cautious investor. You have avoided equity mutual funds and variable annuities because of the possibility of losing too much money. However, you would like to earn more than the low interest rates available on fixed annuities. An equity-indexed annuity may be a good compromise for you. If the value of the underlying equity index increases, your annuity will participate in those gains. If the equity index does not do well, you will still receive a minimum rate of return on your investment, thereby limiting your potential loss.

Upside potential may be limited

With most equity-indexed annuities, the annuity issuer will limit the return on the annuity in a given year (through what is called a cap rate). The cap rate is the maximum return the issuer will credit to the account in any given year. The cap rate may be 10 percent, 12 percent, or some other number. If the underlying equity index does better than this cap rate, the issuer will credit the annuity with only the percentage of the cap rate. If the S & P 500 goes up 20 percent in one year, then the annuity issuer may pay only 12 percent, for example. The annuity issuer may also limit the upside potential through a "participation rate." The participation rate is the percentage of the return on the underlying index that the issuer pays in a given year. Many issuers of equity-indexed annuities, for example, will pay only 75 percent of any return on the underlying index. If the index is up 10 percent for the year, the issuer will credit the annuity account with a gain of only 7.5 percent.

Want to invest money tax deferred

An equity-indexed annuity is also an excellent way to save and to invest money on a tax-deferred basis. As with other annuities, the earnings and capital gains on an equity-indexed annuity accumulate on a tax-deferred basis. You do not have to pay any taxes until you begin to withdraw money from the annuity (which may be at a time when you are in a much lower tax bracket). Because your investment in an equity-indexed annuity can grow tax free for many years, the amount you can accumulate through the annuity may be substantially greater than in a fully taxable account.

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Equity-indexed annuity may be a good substitute for or a good supplement to qualified retirement plan

If you work for a company that does not offer a qualified retirement plan, then investing in an equity-indexed annuity may be a good retirement plan substitute. Although contributions to an equity-indexed annuity are not tax deductible (unlike certain qualified retirement plans), the earnings and capital gains in an equity-indexed annuity will accumulate tax deferred (like a qualified plan). Similarly, if you have already contributed the maximum amount to your qualified retirement plan and you would like to save additional amounts for your retirement, then an equity-indexed annuity may be an excellent way to supplement your qualified plan.

All qualified retirement plans have maximum amounts that you can contribute yearly to the plan. In many cases, the maximum amount that you can contribute each year is less than what you can afford to save for your retirement and what you would like to save for your retirement. Because the earnings and capital gains on an equity-indexed annuity accrue tax deferred, this annuity (and other types of annuities) may be a good way to save additional amounts for your retirement with some tax benefits.

Distribution options

As with other types of annuities, there are several distribution options available for an equity-indexed annuity. You can withdraw just the earnings on the annuity, or you can withdraw both the earnings and the principal. You can withdraw the money from the annuity in one lump sum or through a series of withdrawals. You can also elect to receive a guaranteed income from the annuity (called "annuitizing" the contract). If you annuitize the annuity, you can elect to receive income over your entire lifetime, no matter how long you live. This ability to receive annuity payments over your entire lifetime is one of the unique features of an equity-indexed annuity (as well as with other types of annuities). (Of course, if you die after receiving even just one payment, all of the money invested in the annuity may be gone.) You can also elect to receive annuitized payments for a specific period of time (e.g., 5 or 10 years). For a further discussion of annuity distribution options, please refer to Annuities .

What are the strengths of equity-indexed annuities?

Can participate in stock market advances without giving up minimum interest rate guarantee

The main advantage to an equity-indexed annuity is that it allows an individual to participate in stock market gains if the market performs well, but it also affords some downside protection if the market does poorly. As noted, the annuity issuer guarantees that a minimum annual rate of interest will be paid on the annuity if the performance of the applicable equity index falls below this number. Many companies guarantee that a minimum annual interest rate of 3 percent will be paid on the equity-index annuity. Thus, an individual will make money if the equity index does well but will not lose money if stocks fall in value.

May allow your investments to keep pace with inflation

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Another strength of an equity-indexed annuity is that it may allow your investments to keep pace with or to even outperform inflation over time without the risk of losing your money. Historically, in the long term, gains in the stock market have been greater than the long-term inflation rate in the United States. However, some people are hesitant to invest in the stock market because of the possibility of losing money in the short term. Thus, an equity-indexed annuity may be an excellent investment vehicle for the person who wants the chance of staying ahead of inflation without the risk of losing his or her principal.

Earnings of equity-indexed annuity tax deferred

As with other types of annuities, the earnings on an equity-indexed annuity are not taxed until you begin to withdraw money from the annuity. The earnings accrue tax deferred until distribution begins. At that point, distributions are taxed in whole or in part as ordinary income and you may be in a lower tax bracket than during the accumulation phase. Furthermore, the earnings on the equity-indexed annuity will compound tax deferred in three ways. First, the earnings on whatever payments you make to the annuity accrue tax deferred. Second, the earnings generated by the original earnings accrue tax deferred. Third, the earnings on the money you would have otherwise paid in taxes grow tax deferred. Over time, this triple, tax-deferred compounding can result in substantially larger gains than for a comparable taxable investment.

Distribution options

Another strength of an equity-indexed annuity (as well as with other annuities) is that if you elect to annuitize the annuity and to receive payments over your entire life, you cannot outlive the payments from the annuity. The annuity issuer must continue to make payments to you for as long as you are alive. Unlike with other types of investments, you cannot outlive annuity payments. If you begin receiving annuity payments when you are 65 years of age and you live to be 100, the annuity issuer must continue to make the payments to you for the 35 years. There are no other types of investments with this guarantee.

Can invest unlimited amount of money in equity-indexed annuity

Unlike with qualified retirement plans, such as a 401(k) or an individual retirement account (IRA), there is no limit on how much you can invest in an equity-indexed annuity. With almost all qualified retirement plans, there are fairly low limits on the amount that you can contribute to the plan each year. With an equity-indexed annuity, though, you can invest an unlimited amount of money in the annuity and still receive the partial tax benefits. Furthermore, when distributions are made to you, if you have chosen the annuitization option, part of each distribution is considered to be a tax-free return of the capital that you have invested in the annuity.

Guaranteed death benefit

Like with most other annuities, an equity-indexed annuity will pay your beneficiary a death benefit if you die before you begin receiving payments from the annuity. The exact amount that your beneficiary will receive varies from one annuity issuer to another. Usually, the guaranteed minimum death benefit will be the current value of the annuity or the actual amount of money deposited in the account (net of surrenders), whichever is greater.

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Assets in equity-indexed annuity not subject to probate

If you die before the distribution period begins for your equity-indexed annuity, then the proceeds in the account will go directly to the named beneficiary (or beneficiaries) on the annuity. The assets will not have to pass through probate. Because of the potential costs and time delays of probating assets, it is generally advantageous not to have to probate assets.

What are the tradeoffs to equity-indexed annuities?

Equity-indexed annuities have many complex concepts

Probably the single biggest tradeoff to purchasing an equity-indexed annuity is the complexity of the product. There are many unique features to an equity-indexed annuity that an average annuity purchaser may have difficulty understanding. Among these unique features are indexing, cap rates, participation rates, surrender charges, vesting schedules, and policy terms. Indexing refers to how the annuity issuer pegs the performance of the equity-indexed annuity to an underlying stock market index. The cap rate refers to the maximum rate of return that will be paid in one year, regardless of the performance of the applicable index. The participation rate is the percentage return that the issuer will pay to you based on the index performance. These features, and many of the other features of an equity-indexed annuity, are usually not found with fixed or variable annuities.

Difficult to compare equity-indexed annuity from one company with similar annuity of another company

Another tradeoff to equity-indexed annuities is that it is very difficult to compare an annuity offered by one company with an annuity offered by another company. As noted, there are many complex and unique features to equity-indexed annuities. Each company that issues this type of annuity may offer a product with features that are different from the equity-indexed annuities of other companies. For example, the participation rate may differ from one company to another, the surrender charges may be different, or the cap rate may be higher or lower. It is extremely difficult, then, to compare equity-indexed annuities offered by different companies.

Returns may not be as high as the underlying index

With most equity-indexed annuities, the issuer puts a cap rate on how much it will pay on the annuity in any given year (called a cap rate). The cap rate may be 10 percent, 12 percent, or some other number. If the underlying stock market index (the S & P 500, for example) goes up 20 percent in a year, then the issuer will pay only the cap rate (10 or 12 percent) as the return on the annuity. In the years when the stock market does very well, you may receive a significantly lower return on the annuity. Furthermore, many equity-indexed annuity issuers limit returns further through the participation rate. An annuity issuer may set a participation rate of 75 percent. Thus, in any given year, the company will credit to your annuity account 75 percent of the return on the underlying index. If the index goes up 10 percent in a year, the company will credit a return of 7.5 percent to your account. With most equity-indexed annuities, you will not receive the full return of the underlying index (especially in years when the market performs well). In a sense, you give up some

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of the upside potential for the assurance that you will receive a minimum rate of return if the stock market index performs poorly.

Policy term may be long

The policy term for an equity-indexed annuity is the length of time over which the applicable stock market index is measured. It may also be called the "annuity term," the "term of years," or the "contract term." The policy term may range from 5 to 10 years. During this time period, it may be very difficult and costly for you to withdraw money from the annuity. There can be various surrender charges, tax penalties, and vesting percentages if you take money out of the annuity before the policy term ends. With some equity-indexed annuities, you forfeit all of the market gains if you surrender the policy before the policy term is over. Thus, an equity-indexed annuity may make sense only for individuals who can keep their money in the annuity for a fairly long period of time. It may not be a good investment for someone who may need the money in the short term.

Equity-indexed annuity usually not segregated account

Unlike a variable annuity in which the underlying subaccounts are segregated from the issuing company's general accounts, an equity-indexed annuity is considered part of the issuing company's general account. Thus, if the issuer experiences financial difficulties, there is no guarantee that your annuity will be protected. You may want to research the financial ratings of equity-indexed annuity issuers before you purchase such an annuity.

What are the tax implications of equity-indexed annuities?

Accumulated earnings and capital gains accrue tax deferred

The earnings on an equity-indexed annuity accrue tax deferred until you begin the withdrawals from the annuity. This means that any earnings generated by the annuity will not be subject to income tax until the distribution period begins. The untaxed earnings compound up until the time you begin to receive distributions from the annuity. The tax deferral of earnings is an advantage for an equity-indexed annuity versus other taxable investments. Over a long period of time, your money will compound and grow more rapidly in a tax-deferred account than in a taxable account.

Example(s): You invest \$10,000 in an equity-indexed annuity. You are in the 35 percent tax bracket. You plan to hold the annuity for 30 years and estimate the return on the annuity to be 10 percent per year. After 30 years, you will have \$100,000 more before taxes in the annuity than if you had invested the \$10,000 in a taxable account.

10 percent premature distribution penalty tax

To prevent individuals from using annuities as short-term, tax-sheltered investments, the tax code imposes a 10 percent penalty on premature distributions from the annuity. The penalty generally will apply if the annuity owner is below the age of 59½ when the distribution (or withdrawal) occurs.

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There are some exceptions to the imposition of this penalty. For example, the 10 percent penalty will not be imposed if the annuity owner becomes disabled or dies. More importantly, the penalty will not be imposed if the withdrawals begin before the age of 59½ and they are part of a series of substantially equal periodic payments made for the life of the owner (based on the life expectancy of the owner). Furthermore, the 10 percent penalty applies only to the portion of the premature distribution that is taxable.

Annuity payments partially a tax-free return of capital and partially taxable income

Once you begin to receive payments from the equity-indexed annuity, part of each payment you receive is treated as a tax-free return of capital, and the remaining part of the payment is treated as taxable income. However, unlike with a fixed annuity, you do not calculate an "exclusion ratio" for an equity-indexed annuity. Because the expected return on an equity-indexed annuity is not known at the time the annuity payments begin, your expected return is considered to be the amount you have invested in the annuity. The amount that you can then exclude each year from your taxable income is the amount you have invested in the annuity divided by the number of years that it is anticipated that the payments will be made to you (the same calculation as for a variable annuity). The remaining portion of the annuity payment is then considered to be taxable income.

Caution: If the starting date for the annuity is after December 31, 1986, the total amount that can be excluded from your taxable income is the amount you have invested in the annuity. After you have recovered your investment in the annuity, the entire annuity payment to you must be included in your taxable income.

Example(s): You have invested \$200,000 in an equity-indexed annuity. You began to receive annuity payments last year when you retired at age 65. Your remaining life expectancy at this point is 20 years. The annuity will pay you \$20,000 per year for the remainder of your life. You can then exclude \$10,000 of this annual payment from your taxable income (\$200,000 divided by 20 years). The remaining \$10,000 must be included in your taxable income. You can exclude the \$10,000 per year only up to the point at which you have fully recovered your investment in the annuity. Thus, if you live for more than 20 years, the full annuity payment (\$20,000) must be included in your taxable income after that point.

Value of equity-indexed annuity contract may be included in your taxable estate if you die before payments begin

If you die before the payments begin from the equity-indexed annuity, then the value of the annuity contract must be included in your taxable estate. In such a case, the equity-indexed annuity will pay a death benefit either to your estate or to the named beneficiary or beneficiaries. The IRS considers you to be the owner of the death benefit at the time of your death, and thus the benefit must be included in your taxable estate, even if it is payable to another beneficiary. The one exception to this rule is if you had previously gifted the annuity to another person and you do not retain any interest in the annuity or the payments from the annuity. However, the gift of an annuity may have gift tax implications.

Example(s): You are 50 years old and had purchased an equity-indexed annuity 5 years ago. The annuity is scheduled to begin paying benefits to you when you reach

65, but you die when you are 60. At this point, the annuity must pay your estate a death benefit of \$50,000. The \$50,000 must be included in your taxable estate even if the death benefit is payable to another beneficiary (e.g., your child).

Estate tax treatment of annuity after payments begin can vary depending on type of settlement option

Once the annuity payments have begun, the estate tax treatment of an equity-indexed annuity will vary, depending on the settlement option that you select. If you elect to receive payments under a straight life annuity, then the value of the annuity does not have to be included in your taxable estate when you die because the payments will end at your death. In a sense, there is nothing of value to be included in your taxable estate. However, if you elect a settlement option that includes a survivor benefit (such as a joint and survivor annuity), then the value of the annuity payments to be made after your death must be included in your taxable estate. The value of this annuity to be included in your taxable estate is calculated by figuring out what the annuity issuer would charge the survivor to purchase a single life annuity at the time of the first annuitant's death.

Example(s): You have reached the age at which the equity-indexed annuity you purchased five years ago is scheduled to begin annuity payments to you. You select the straight life settlement option whereby you will receive \$2,000 per month for the rest of your life. You die three years later. Because the payments stop at your death, there is nothing to include in your taxable estate. However, if you had selected a joint and survivor settlement option with your spouse (whereby the payments would be made over both your lives), then the value of the payments to your spouse would have to be included in your estate at your death. This value is usually calculated by using the amount that the annuity issuer would charge your spouse for a single life annuity at the time of your death.

Taxation of annuities very complicated

Both the income and estate taxation of equity-indexed annuities are very complicated. For a more detailed discussion of all the tax issues of annuities, please refer to *Taxation of Annuities* .

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Final Page - Disclaimer

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