Annuity Suitability: NAIC Model Act Requirements

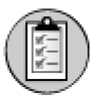
Contents

Introduction

The requirement that recommendations concerning financial transactions—including such transactions involving annuities—that are made by financial professionals to their clients must be suitable for those clients has always been an ethical mandate. If the recommended financial transaction involved a security, the requirement for suitability also became a legal requirement.

Over the years, recommendations of other financial transactions not necessarily involving securities became a legal requirement when they met specified conditions. In some jurisdictions, annuity transactions involving seniors or in which product-replacement recommendations were made also became subject to legal requirements.

In an effort to coordinate insurance regulations across multiple jurisdictions and promote regulatory consistency, the National Association of Insurance Commissions (NAIC), a regulatory support organization, develops model regulations that jurisdictions may use to craft appropriate insurance legislation. That effort to coordinate state regulation and promote consistency has resulted in the NAIC's publication of model legislation titled the "Suitability in Annuity Transactions Model Regulation." This course will examine that model regulation and will identify and discuss its requirements.


Objectives

Learning Objectives

This course will examine the requirements imposed on insurers and insurance producers by the NAIC Suitability in Annuity Transactions Model Regulation.[1] When you have completed the course, you should be able to:

- *Identify types of consumer information that must be obtained and which forms the basis for annuity suitability analysis;*
- *Explain the concept of suitability;*
- *Describe the use of each of the required items of consumer suitability information in performing suitability analysis; and*
- *List the various annuity features about which a consumer must be reasonably informed.*

National Association of Insurance Commissioners

The National Association of Insurance Commissioners (NAIC)[2] was created in 1871 by the state insurance regulators. It functions as an organization designed to assist state insurance regulators in meeting various regulatory goals and is governed by the chief insurance regulators of the 50 states, the District of Columbia and the five U.S. territories.

The goals the NAIC seeks to achieve are:

- Protecting the public interest;
- Promoting competitive markets;
- Facilitating the fair and equitable treatment of insurance consumers;
- Promoting the reliability, solvency and financial solidity of insurance institutions; and
- Supporting and improving state regulation of insurance.

Among the NAIC's various activities in support of those goals is the drafting of model regulations designed to help ensure that insurance consumers are treated fairly and promote increased consistency in state insurance laws and regulations. Its "Suitability in Annuity Transactions" model regulation is such a document.

The NAIC Suitability in Annuity Transactions model regulation addresses requirements related to:

- Obtaining consumer suitability information;

---

[1] Suitability in Annuity Transaction Model Regulation (MDL-275). National Association of Insurance Commissioners. 2nd Quarter 2015. Accessed July 3, 2018. https://store.naic.org/store/free/MDL-275.pdf?14.

[2] The NAIC Website may be accessed at http://www.naic.org.

- Annuity transaction suitability and its mitigation in certain situations;
- Ensuring annuity consumers are reasonably informed concerning various annuity features;
- Documentation;
- Insurer supervision;
- Producer training; and
- Penalties and compliance mitigation.

While the requirements mandated in the model regulation are intended to be broadly applied, they do not apply to certain exempt transactions. The annuity transactions that are exempted from the requirements of the NAIC Suitability in Annuity Transactions model regulation are transactions involving:

- Direct response solicitations where there is no recommendation based on information collected from the consumer; or
- Contracts used to fund –
    - An employee pension or welfare benefit plan covered by ERISA,
    - A plan described by IRC sections 401(a), 401(k), 403(b), 408(k) or 408(p) if maintained by an employer,
    - A government or church plan defined in IRC section 414, a government or church welfare benefit plan, or an IRC section 457 deferred compensation plan of a state or local government or tax exempt organization,
    - A nonqualified deferred compensation arrangement,
    - Structured settlements, or
    - Formal prepaid funeral contracts.

Heightened Standard When Fiduciary Rule Applies

In recent years, there has been controversy over whether commissioned agents have a conflict of interest, due to the commission itself, when they recommend annuities, particularly high-commission products. This has led a variety of regulatory bodies and professional societies to require that the agent act as a fiduciary in the "best interest" of the client, to put the client's interest ahead of the agents and, in some cases to be paid on some basis other than commissions.

There are many ways an agent could be considered a fiduciary. Here is a list of possibilities (there may be more). The agent could be:

- A registered investment advisor;
- A member of a professional association or hold a designation that requires you to act as a fiduciary;
- A trustee or agent under a power of attorney for your;
- Giving advice under an agreement with a client that states that you are a fiduciary; or
- Giving advice on a *regular basis* to a client in the context of a retirement plan covered by ERISA.

In April 2016, the U.S. Department of Labor (DOL) issued a set of rules to apply the fiduciary standard investment advice provided to employer-sponsored retirement plans, IRAs, and their participants. In the area of annuities, these rules partially overlap the NAIC annuity suitability rule—particularly in the area of advice to IRAs and their owners. In May 2018, before the rule was scheduled to be fully implemented, however, it was vacated nationally by the U.S. Court of Appeals for the 5th Circuit.

This is not the end of the story, however. The Securities and Exchange Commission is considering some form of the fiduciary best interest standard, and the NAIC is considering modification of its NAIC annuity suitability rule to incorporate a best interest standard, as well. As this course was written, neither body had yet taken action. And, of course, the fiduciary standard already does apply in the cases noted above.

What is the fiduciary standard? A short answer includes two components:

- **Duty of care.** The fiduciary duty of care is similar to the suitability analysis that we have already discussed in this course, but with a heightened level of diligence. The agent must know the client and the client's need. The agent must know the costs and benefits of the

products being recommended. And the agent's analysis must support the recommendation as being in the best interest of the client.
- **Duty of loyalty.** The fiduciary duty of care requires the agent to be focused on the client's best interest and not any interest of the agent. There must be no conflict of interest (in some, but not all cases, disclosed conflicts may be waived, depending on the specific rule). A major source of conflicts comes from commissioned products where a commission differential between products might be considered an improper incentive for an agent to recommend a product. Other conflicts, of course, are possible and must be avoided.

Best practices dictate (and in many cases the law or professional rules demand) careful documentation of the reasons for any recommendation in order to show that the standard of care has been met.

Protections for Senior Clients

Much of the push behind the development of client protections in the annuity market came from the approaching retirement of the baby boomers. Suitability is only part of the scheme for protecting retirees. Heightened concern for the financial risks of older clients is becoming a daily part of an agent's business. This includes preparing for the possibility that the client's capacity to handle financial matters may diminish over time and being alert for scam artists who like to prey on older individuals.

The details of these protections are beyond the scope of this course, but agents who sell annuities inevitably deal with older clients and should be aware of protections that apply. The details vary in each state, but include things like

- getting the client to identify a trusted individual who can receive information on the account (otherwise, general privacy laws may prevent that);
- immunity from legal liability when an agent reports suspected financial exploitation of a senior client to the authorities (this is also part of federal law under the 2018 Senior$afe Act); and
- procedures for delaying disbursement of funds when financial exploitation is suspected (FINRA Rule 2165 and a 2016 model law proposed by the North American Securities Administrators Association both cover this).

We are not going to try to guess where these changes might lead, but will concentrate in this course on the rules that now exist. So let's examine the Suitability in Annuity Transactions model regulation requirements related to required data-gathering, suitability and disclosure applicable to non-exempt transactions.

1.0 Obtaining Consumer Suitability Information

Before a consumer purchases an annuity or replaces/exchanges one as a result of a recommendation, the insurance producer (or insurer if no producer is involved) must make reasonable efforts to obtain the consumer's suitability information. Suitability information is the consumer information that is appropriate to serve as the basis on which to determine the suitability of a recommendation and includes information concerning the consumer's:

- Age;
- Annual income;
- Financial situation and needs, including the financial resources used for funding the recommended annuity;
- Financial experience;
- Financial objectives;
- Intended annuity use;
- Financial time horizon;
- Existing assets, including investment holdings and life insurance ownership;
- Liquidity needs;
- Liquid net worth;
- Risk tolerance; and
- Tax status.

The relevant NAIC Suitability in Annuity Transactions model regulation text provides as follows:

> 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. (Section 6B)

Let's briefly consider how each of these pieces of consumer suitability information could impact the annuity suitability analysis.

1.1 Consumer's Age

Annuity suitability for a particular consumer can be substantially affected by the consumer's age. Principal among the reasons why a consumer's age would impact the suitability of an annuity for him or her are:

- The existence of surrender charges imposed on contract surrenders and withdrawals exceeding an annual surrender charge-free withdrawal limit; and
- The tax treatment to which distributions other than as an annuity are subject.

Surrender charges and the tax treatment of distributions affect annuity suitability as discussed in the following sections.

1.1.1 Surrender Charges may Make Deferred Annuities Unsuitable for Older Consumers

Distribution and other sales expenses incurred by an insurer are substantial in the year it issues an insurance product, including a deferred annuity contract. In fact, depending on the type of insurance product, the insurer may actually incur business acquisition expenses that exceed its revenue obtained from the sale in the first contract year. However, over time, the insurer recovers its business acquisition expenses by deducting sales charges from premiums it receives and/or by taking monthly deductions from the cash value.

An annuity contract owner who surrenders the annuity contract or takes a distribution from its cash value in excess of any surrender charge-free limit before the insurer's business acquisition expenses have been fully recovered—a duration known as the contract's surrender charge period—generally faces surrender charges. And, depending on how long the deferred annuity has been in force and its surrender charge provision, the amount of the surrender charges may be substantial.

Although any insurer's surrender charge provision may differ, such charges may be as indicated in the hypothetical surrender charge chart shown below:

Contract Year	1	2	3	4	5	6	7	8	9	10	11 & later
Surrender Charge	10%	9%	8%	7%	6%	5%	4%	3%	2%	1%	0%

Certain types of annuities—annuities referred to as "bonus annuities," for example—may involve an even greater surrender charge than the surrender charge schedule shown above. For example, an annuity on which a contract owner has received an additional interest amount credited to the cash value—an amount often referred to as a "bonus"—is likely to impose higher surrender charges and longer surrender charge periods in order to recover the insurer's increased business acquisition expenses incurred because of the additional interest crediting.

Because of these surrender charges a deferred annuity may be unsuitable for an older consumer. The unsuitability can result from the possibly large surrender charge for which an older consumer may be liable when he or she wishes to begin taking income from the deferred annuity through withdrawals, by surrendering it or by annuitizing its cash value. Such surrender charges may reduce the consumer's available cash significantly.

1.1.2 Tax Treatment may Make Annuities Unsuitable for Younger Consumers

Annuities may also be unsuitable for younger consumers for other reasons. In addition to the possible imposition of surrender charges for surrenders or distributions from deferred annuities—a consideration in the case of younger consumers who may be facing the need for cash to meet the usual family requirements—the generally-unfavorable tax treatment afforded distributions from deferred annuities may also make them unsuitable for younger consumers.

Distributions from deferred annuity contracts are subject to:

- Unfavorable LIFO tax treatment; and
- Possible premature distribution tax penalties.

1.1.2.1 LIFO Tax Treatment of Withdrawals and Loans

The gain experienced in a deferred annuity as a result of the insurer's crediting of interest to the cash value is tax-deferred until it is distributed. Thus, the tax-deferred gain may build up substantially over the many years the annuity is held by a contract owner. The total unrecognized (for tax purposes) interest credited to an annuity's cash value is considered contract gain. So, at any time, a nonqualified deferred annuity's cash value is comprised of a) accumulated premiums which would be tax-free when distributed and b) tax-deferred gain which would be taxable as ordinary income when distributed.

A distribution from a deferred annuity's cash value as a result of a withdrawal or loan is deemed to come first from the annuity's gain that is subject to income taxation as ordinary income. Only after all gain has been distributed will any further distribution from the annuity be considered tax-free as a recovery of the contract owner's cost basis. This is known as "last in, first out" (LIFO) tax treatment.

For example, suppose a consumer who had purchased a deferred annuity made premium payments of $20,000 and had a cash value of $25,000. The cash value would then be comprised of $20,000 that represents the premiums paid and $5,000 of gain. A distribution—a cash value withdrawal or loan, in other words—of $7,000 would require that the contract owner recognize the entire $5,000 gain as ordinary income. Only the remaining $2,000 of the distribution would be considered tax-free as a recovery of the contract owner's cost basis represented by the premiums paid.

1.1.2.2 Premature Distribution Tax Penalties

Tax-deferral of gain—a characteristic of deferred annuity contracts—can result in substantially greater accumulations over time than may be enjoyed in otherwise identical nonqualified accounts whose gains are currently-taxable rather than tax-deferred. That favorable tax treatment of gain which generally provides an accumulation advantage to deferred annuities was permitted by Congress as a means of helping contract owners to more easily accumulate capital to fund a supplemental income at retirement.

As a way of ensuring a deferred annuity is used only to meet a client's long-term objectives, principal among which is the creation of a retirement fund, a tax penalty is imposed on distributions of gain from a nonqualified deferred annuity made before age 59 1/2. Such distributions are referred to as "premature distributions" and are subject to a tax penalty equal to 10% of the portion of the distribution includible in the contract owner's income.

In the prior example, a consumer took a $7,000 distribution from a deferred annuity whose cash value had a $5,000 gain, and the entire $5,000 gain was deemed distributed, includible in the consumer's gross income and taxable at ordinary income rates. If the consumer was younger than age 59½ at the time of the distribution and no exception to the premature distribution tax penalty applied, the consumer would be liable for a $500 additional tax, i.e. the 10% tax penalty, along with the tax due on the $5,000 included in income as a result of the distribution. ($5,000 x 10% = $500)

The exceptions to the premature distribution tax penalty apply to distributions:

- Made on or after the individual becomes age 59½;
- Attributable to the individual's becoming disabled;
- Allocable to investment in the contract before August 14, 1982;
- Made on or after the contract owner's death;
- Made under an immediate annuity contract;
- Made from an employer-purchased annuity upon the termination of a qualified plan; and
- That are part of a series of substantially equal periodic payments made for the life or life expectancy of the individual or the joint lives or joint life expectancies of the individual and his or her designated beneficiary.

Because of the additional limitation on liquidity that results from premature distribution tax penalties applicable to younger consumers, the age of a younger consumer needs to be considered in any deferred annuity suitability analysis, and such information must be obtained by the insurance producer.

1.2 Annual Income

The overwhelming majority of consumers rely on their income rather than on their accumulated wealth to provide the funds needed to purchase food, clothing and shelter as well as to provide for their future. Not surprisingly, for such consumers considering the purchase of an annuity, the extent of their annual income relative to the claims on it to meet other obligations—to provide for the education of children, to purchase needed medications, etc.—is an important consideration in deferred annuity suitability analysis and a prime reason for its inclusion as part of the required suitability information that must be obtained.

Consider a possible real-life example. Suppose a consumer considering the purchase of a deferred annuity would be required to forgo the funding of his children's higher education or the purchase of needed life insurance in order to afford to buy it. While such considerations might not necessarily make the purchase of a deferred annuity unsuitable if other arrangements could be made to meet those competing needs, the consumer's annual income would clearly be an important element in the suitability analysis.

1.3 Financial Situation and Needs

The consideration of a consumer's financial situation and needs overlaps, to some extent, the need to consider the consumer's annual income in the determination of deferred annuity suitability. The requirement to obtain information concerning a consumer's financial situation and needs means that an insurance producer must gather information concerning the consumer's:

- Cash flow;
- Outstanding debts;
- Obligations to family members;
- Financial resources available to fund an annuity; and
- Other financial obligations and income.

Although the changes in an individual's financial situation and needs that could affect his or her ability to successfully maintain an annuity once purchased are virtually unlimited, some possible needs may be fairly obvious and detectable when performing a suitability analysis:

- A consumer's cash flow may be erratic such that a large income decline would require the consumer to access the annuity's cash value to meet day-to-day cash needs; or
- A looming debt repayment may similarly mean the consumer requires a premature distribution from the annuity—a large withdrawal or complete surrender, in other words—with its possible tax penalties and surrender charges.

Because of the wide range of possible changes in the individual's financial situation and needs that could negatively affect the suitability of an annuity for a consumer, a thoroughgoing data gathering must be done to elicit the appropriate information and consider it in making a suitability analysis.

1.4 Financial Experience

It is no secret that, in general, insurance products tend to be more complicated and difficult for consumers to understand than other financial products. Thus, while a consumer with a substantial amount of financial experience, particularly having to do with variable annuities, might easily be able to track the value of each of his or her variable annuity's subaccounts, a consumer without that experience may find such an attempt to be completely foreign. Accordingly, a consumer with little or no financial experience is far more likely to be dissatisfied by purchasing a highly complex financial product like an annuity.

While a consumer's lack of financial experience doesn't necessarily render an annuity unsuitable, it is another aspect of the consumer that an insurance producer should know about and take into consideration when determining suitability.

1.5 Financial Objectives

Consumers invest their funds in order to accomplish various personal financial objectives, i.e. the goals the consumer expects to be able to accomplish by making the investment. Although consumers' financial objectives are likely to have varying levels of importance depending on a range of variables that include the consumer's age, family size, income level and the amount of currently accumulated wealth, certain objectives have a high priority with many consumers.

The financial objectives that are often important to consumers include the ability to:

- Meet emergency financial needs, e.g. the need for long term care or medical care for a serious illness;
- Purchase expensive personal assets, such as a luxury automobile, yacht or new home;
- Pay children's higher education expenses;
- Enjoy a sufficient retirement income; and
- Accumulate wealth.

The purchase of a financial product, such as an annuity, is simply a method by which financial objectives that are appropriate to the investment product may be realized. An insurance producer's understanding of the consumer's financial objectives—an understanding that is realized only through gathering and analyzing information obtained from the consumer—is central to determining if an annuity is suitable.

Because of the relatively high expense levels, the existence of surrender charges and the generally adverse tax treatment of non-annuity distributions, a deferred annuity is suitable only to enable the consumer to meet long-term financial objectives.

1.6 Intended Annuity Use

Annuities, because of their relatively high expense levels, their surrender charges that may extend for ten or more years and their tax treatment, are inappropriate to enable consumers to meet short-term objectives. Instead, an annuity is most suitable to meet the objectives of a consumer who intends to use the annuity to accumulate funds for retirement and/or to distribute the accumulated funds through periodic payments. Because of the general unsuitability of an annuity to meet other, shorter-term objectives, an insurance producer must determine to what use the consumer intends to put the annuity in order evaluate its suitability.

1.7 Financial Time Horizon

A consumer's financial time horizon refers to the duration of the holding period for any investment. In other words, a consumer's financial time horizon is the date on which the consumer wants to accomplish his or her financial objective for which the investment was purchased. Thus, a 45 year-old consumer who wants to use his or her annuity to provide a retirement income beginning at age 65 has a 20 year financial time horizon.

In general, for a deferred annuity to be suitable for a consumer, assuming it is suitable in all other respects, the consumer's financial time horizon should not be shorter than the longer of the following:

- The length of time until the consumer's age 59 ½; or
- The duration of the annuity's surrender charge period.

A consumer who intends to use an annuity to accumulate funds to meet short-term goals—funding children's education or paying for a vacation, for example—is likely to find that the combination of higher annuity expenses that act as a drag on accumulations (and which are only overcome by *long-term* tax deferral), surrender charges that reduce distributions, LIFO tax treatment and possible tax penalties make alternatives to deferred annuities far more attractive. Accordingly, an insurance producer's knowledge of a consumer's financial time horizon can help ensure that an appropriate and suitable investment is recommended.

1.8 Existing Assets

An insurance producer needs to understand the extent and allocation of the consumer's existing assets. Although a consumer's assets include all the property—from cash in savings accounts to vacation cottages and everything in between—he or she owns, particular inquiry needs to be made as to the consumer's investment holdings and life insurance ownership and their likely ability to enable the consumer to meet individual and family financial needs.

When determining the suitability of an annuity recommendation, an insurance producer should determine a) if the existing assets will enable the consumer to meet family needs if he or she dies prematurely, and b) if the consumer's asset composition after the annuity is purchased is appropriate to enable the consumer to meet his or her foreseeable financial needs.

In assessing the sufficiency of existing assets, including life insurance, the producer should consider:

- Outstanding consumer debts;
- Survivor cash needs, including cash for children's education, mortgage redemption, burial and final expenses, and estate settlement costs; and
- Survivor income needs.

1.9 Liquidity Needs

Liquidity needs refer to the consumer's need for cash to meet foreseeable expenses. A consumer with high liquidity needs has a requirement for a higher level of cash to meet upcoming expenses—for tuition, a balloon payment on an outstanding note, etc.—than a consumer with lower liquidity needs. Thus, in order to make a recommendation that is suitable, an insurance producer must obtain consumer information related to anticipated cash needs in the foreseeable future.

Because deferred annuities are illiquid investments—they cannot generally be converted to cash easily and without loss of value, in other words—due to their surrender charges, unfavorable tax treatment, high expense levels and possible premature distribution tax penalties, they are likely to be unsuitable for consumers with high liquidity needs that are unmatched by high levels of liquidity in other investments.

1.10 Liquid Net Worth

In order to ensure that a consumer's identified liquidity needs can be met an insurance producer must determine the extent of the consumer's liquid assets. Liquid net worth refers to the total assets held by the consumer that are easily convertible into cash at little or no loss of value.

A consumer's liquid net worth consists of the aggregate value of his or her:

- Savings accounts;
- Cash and cash equivalents;
- Publicly-traded stocks and bonds; and
- Mutual funds.

Not surprisingly, liquid net worth does not include assets that cannot be easily converted to cash or assets whose conversion to cash would result in substantial value loss. Accordingly, assets *not* considered liquid include:

- Real estate holdings, including residences, vacation homes and raw land;
- Closed corporation stock;
- Equity in the consumer's business;
- Vehicles; and
- Other tangible personal property.

In order for a deferred annuity to be suitable for a client, the client must have sufficient liquid net worth from other investments to meet his or her foreseeable liquidity needs. If the client does not have that level of liquid net worth, a deferred annuity would generally be unsuitable.

1.11 Risk Tolerance

As part of the data gathering required to obtain the necessary consumer suitability information, an insurance producer is expected to elicit information concerning the consumer's tolerance for risk. Risk tolerance refers to the level of volatility in the value of an investment that a consumer is willing to tolerate. Accordingly, a consumer's risk tolerance level is likely to be affected by:

- The total amount of the consumer's investment assets – generally, a consumer's *financial* tolerance for risk increases as his or her wealth increases;
- The consumer's financial time horizon – usually, a consumer has greater tolerance for risk with respect to funds invested to meet goals with extended time horizons;
- The consumer's other financial responsibilities – a consumer who has no dependents or others for whom he or she has no financial responsibility is likely to have a higher risk tolerance, both financially and psychologically, than a consumer who has substantial financial responsibilities; and

- The consumer's personality – some consumers have personalities that enable them to tolerate high levels of risk—even seeking out such risks—without any personal discomfort, while other consumers eschew investment risk despite their financial ability to handle it.

While other models of consumer risk tolerance identify additional levels of risk tolerance—conservative to moderate and moderate to aggressive, for example—a consumer's risk tolerance may generally be considered:

- Conservative if the most important concern is capital preservation and the consumer has an extremely low tolerance for possible investment loss;
- Moderate if the consumer is will to accept the possibility of some principal loss in order to achieve potentially higher returns; or
- Aggressive if the consumer is willing to accept the possibility of substantial loss—possibly as high as a 40% loss within a one year period—in order to achieve potentially very high returns.

Not surprisingly, the type of annuity that may be suitable, if any, for a consumer is affected by his or her risk tolerance.

1.12 Tax Status

Although deferred annuity distributions received as other than periodic payments are subject to unfavorable LIFO tax treatment and possible tax penalties for distributions earlier than a consumer's age 59 ½, annuities also offer contract owners an important tax benefit: deferral of taxation of gain until distributed. The value of the tax-deferral of gain is twofold:

- It permits a tax-deferred account to achieve potentially greater accumulations than an otherwise identical account that is currently-taxable since the funds withdrawn from a currently-taxable account to pay the tax liability remain in the tax-deferred account to earn additional interest; and
- The timing of the tax liability may be moved from a period of high income tax liability while the consumer is employed to a period of lower income tax liability while the consumer is retired.

In order for a consumer to achieve a deferred annuity tax benefit, the consumer should a) have some current income tax liability, and b) anticipate that he or she will be in an income tax bracket at the time annuity funds are distributed that is not higher than during the annuity's accumulation period.

Section Review

1.13 Section Review

1. Why would knowledge of a consumer's age be important for purposes of determining annuity suitability?

   A. Taxation of annuity gain reduces as a consumer becomes older

   B. All insurer annuity charges end when a contract owner reaches age 65

   C. Because of the existence of surrender charges and the tax treatment of distributions

   D. Annuities cannot be purchased by consumers younger than age 50

2. Henry paid $50,000 in premiums for his nonqualified deferred annuity contract and had never previously taken a distribution from it. Last year, when the annuity's cash value was $55,000 he took a cash value $6,000 loan. How much income must Henry recognize, if any, for tax purposes as a result of taking the annuity loan?

   A. $6,000

   B. $5,000

   C. $1,000

   D. $0

3. Annuities are inappropriate to meet a contract owner's short-term needs for all of the following reasons EXCEPT
   A. Annuities have relatively high expense levels
   B. An annuity's surrender charge period may be of long duration
   C. Annuity periodic payments cannot begin before the contract owner's age 65
   D. Tax treatment of annuity distributions other than as periodic payments is unfavorable
4. Which of the following would be considered part of a consumer's liquid assets?
   A. Publicly traded stocks
   B. A vacation home
   C. A vehicle
   D. Works of art
5. Shirley's most important concern with respect to her investment in an annuity is that her capital be preserved. Which of the following would characterize her risk tolerance level?
   A. Aggressive
   B. Moderately aggressive
   C. Moderate
   D. Conservative

2.0 Annuity Transaction Suitability

The Suitability in Annuity Transactions Model Regulation requires that the consumer information discussed in Section 1 be obtained. However, the principal focus of the model regulation relates to the use to which that consumer information is put.

Specifically, after an insurance producer has obtained the necessary consumer information that constitutes the total of his or her "suitability information," the insurance producer must have reasonable grounds for believing—based on that information—that an annuity recommendation is suitable.[3] In practical terms, that requirement means the insurance producer is expected to apply the consumer information in conducting a suitability analysis.

The suitability analysis called for under the model regulation requires that the insurance producer have a reasonable basis to believe that the recommendation is suitable for the consumer on the basis of the facts disclosed by the consumer. Furthermore, the insurance producer must also have a reasonable basis to believe that all of the following are true:

- The consumer would benefit from certain annuity features, such as –
    - Tax-deferred growth,
    - Annuitization benefits,
    - Death benefits, or
    - Living benefits;
- Based on the consumer's suitability information the annuity is suitable, with respect to –
    - The annuity as a whole,
    - The underlying subaccounts, if any, to which funds are allocated at the time of purchase or exchange,
    - Any riders or product enhancements, and
    - Any exchange or replacement; and
- Any recommended annuity exchange or replacement is suitable, taking into consideration whether the consumer –
    - Will incur a surrender charge,
    - Will be subject to the commencement of a new surrender charge period,
    - Will lose existing benefits, such as death benefits, living benefits or other contractual benefits,
    - Will be subject to increased fees, investment advisory fees or charges for riders and similar product enhancements,
    - Would benefit from product enhancements and improvements, and
    - Has had another annuity exchange or replacement, particularly one within the preceding 36 months.

Let's look at what each of these suitability requirements mean for insurance producers who recommend and sell annuity contracts.

2.1 Benefitting from Annuity Features

Although annuities have many features in common with other investments, certain features are unique to them. Principal among those unique features are:

- Tax deferral of gain until distributed;
- Annuitization benefits;
- Death benefits; and
- Living benefits.

The higher expenses characteristic of annuities when compared with other investments are attributable, in large part, to these unique annuity features. Accordingly, in order for an annuity to be suitable for a particular consumer, assuming it is otherwise suitable, the consumer should be able to benefit from one or more of those features. Otherwise, the higher annuity expenses would have been incurred by the consumer without having benefitted from the features responsible for the higher expenses. It is not necessary that the consumer benefit from all the unique features of an annuity. It

[3] Suitability in Annuity Transactions model regulation, Section 6.A.

is only necessary that he or she be able to benefit from one of them in order for an otherwise suitable annuity to be considered suitable.

The relevant NAIC Suitability in Annuity Transactions model regulation text provides as follows:

> 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 shall have reasonable grounds for believing that … on the basis of the facts disclosed by the consumer … that there is a reasonable basis to believe … [t]he consumer would benefit from certain features of the annuity, such as tax deferred growth, annuitization or death or living benefit. (Section 6.A.(2))

2.1.1 Tax-Deferral of Gain

It was noted in Section 1 that tax-deferral of gain can result in greater accumulations over time than may be experienced in otherwise identical nonqualified accounts whose gains are currently-taxable rather than tax-deferred. The singular reason for the enhanced accumulation that may occur in a tax-deferred account is because the funds that would be used to pay the tax liability in a currently-taxable account are permitted to remain in a tax-deferred account to earn additional interest.

We can see the value of tax deferral by looking at the accumulation differences between a tax-deferred account and an otherwise identical currently-taxable account at various durations. For purposes of illustration, assume that a consumer in a 35% income tax bracket made $10,000 annual contributions to each of the accounts, that each account provided annual interest crediting at 5%, and that a withdrawal equal to the consumer's income tax liability for the interest credited to the currently-taxable account was made from that account each year. Based on the assumptions, the accumulations in each of the accounts would be as shown in the chart below:

Year	Tax-Deferred Accumulation	Currently-Taxable Accumulation (35% tax rate)	Difference
10	$125,779	$115,967	$9,811
20	$330,660	$275,642	$55,017
30	$664,388	$495,498	$168,890

There would appear to be little question, assuming that the two accounts were identical, that a consumer in a 35% income tax bracket would be well served by accumulating funds in a tax-deferred account. Many illustrations of annuities, stop here. But there is a difference when the customer takes the money out. The growth in the tax-deferred account was only tax-deferred, so the tax comes due when the money is withdrawn. The growth in the currently-taxable account was already taxed and isn't taxed again. So let's look at how this plays out with both accounts, assuming the same 5% interest, but assuming that the individual is in a lower tax bracket during retirement (24%).

	From Tax-Deferred Account	From Currently Taxable Account
Balance in account when annuitized	$664,388	$495,498
Tax basis (portion already taxed; also called tax basis or "investment in the contract")	$300,000	$495,498
Annual distribution if account value is annuitized over 30 years	$43,219	$32,233
Annual tax on distribution (24%)	$7,973	$3,772
Annual distribution after taxes	$35,247	$28,461

The tax-deferred account still maintains its advantage, but it is less because the tax will be higher withdrawing from the tax-deferred account than it would be withdrawing from the currently taxable account. Of course, these figures can change drastically depending on the interest and tax bracket assumptions that are made. The advantage of the annuity is greatest when the tax rate is highest and less so when the tax rate is lower. If your client is fortunate enough to be in a higher tax bracket after retirement than before, the advantage of the tax-deferred account shown here could be erased. That is not the typical scenario, but it is not impossible. People's tax rates do not remain constant for decades. But you do have to make some sort of assumptions. So, in determining whether a consumer would benefit from tax deferral such that the benefit derived from tax-deferral would overcome the higher annuity expenses, the insurance producer must consider the consumer's income tax bracket and the intended duration of the accumulation period. If the consumer's income tax bracket is low or if the accumulation period is relatively short, the consumer's benefit derived from tax-deferral is reduced.

2.1.2 Annuitization Benefits

Regardless of whether a deferred annuity's cash value is annuitized under one of the settlement options available in the deferred annuity contract or a consumer annuitizes principal through the purchase of an immediate annuity, annuitization benefits are central to the product's identity and unique ability. Under annuitization a principal sum is liquidated over time through periodic payments made monthly, quarterly, semi-annually or annually. To fully appreciate the unique character of annuitization benefits we need to look at a possible real life situation.

Suppose a 70 year-old consumer is about to retire and has managed to accumulate $1 million with which to fund his retirement income. As he thinks about his investment options, he considers some obvious potential choices: a money market fund and Treasury bonds. Although both options offer significant safety of principal, they don't produce enough income for the consumer. Based on an assumed 3.5% average annual yield, the consumer can expect an average annual income of $35,000.

In order to increase the income he would receive, the consumer decides to consider liquidating the $1 million principal over his 17-year life expectancy. Assuming he can achieve a consistent 3.5% annual interest on the remaining balance, the consumer can increase his annual income to $76,370 by living on principal and interest as he liquidates the $1 million principal over the next 17 years. His concern, however, is that he may live longer than his life expectancy, and his income will run out before his life does.

The answer for the consumer may be to use the $1 million principal to purchase a life annuity. By doing so, he can expect a $78,000 annual fixed income for his entire lifetime, no matter how long he lives and, if he is willing to accept the risk of variable annuitization, his periodic payments may increase over time to counteract the purchasing power erosion resulting from inflation. Regardless of the life annuity method he chooses, if he lives to age 95 his income will have continued for eight years beyond his life expectancy at the time he purchased the annuity.

The downside to life annuitization either through purchasing an immediate life annuity or by annuitizing the cash value of a deferred annuity under a life annuity settlement option is that the funds annuitized are no longer available to the consumer. Thus, once annuitization begins no further loans or withdrawals are usually possible.

2.1.3 Death Benefits

Virtually all investments offer benefits payable to an investor's heirs at his or her death. The death benefit under the majority of investments is simply equal to the value of the investment at the owner's death. Thus, superior investment results will offer the beneficiary a larger benefit, and poor investment results will yield a smaller benefit—or no benefit at all.

Deferred annuities offer consumers an additional guarantee: that the death benefit will never be less than the amount invested minus any distributions taken by the consumer and may be much more than that guaranteed amount.

Insurers may offer the following types of death benefits under their deferred annuities:

- A traditional death benefit that may be available on any type of deferred annuity that is equal to the greater of -
    - Net premiums paid[4], or

[4] The term "net premiums," as used in reference to deferred annuity death benefits, means the contract owner's aggregate premiums paid less any cash value distributions taken.

        - Cash value on the date of death; or

- A death benefit available on deferred variable annuities that is equal to –
    - The greater of
        - Net premiums paid (plus hypothetical interest), or
        - Cash value on the date of death—sometimes referred to as a *rollup*; or
    - The greater of –
        - Net premiums paid, or
        - The greater of the cash value on the date of death or on specified anniversaries—sometimes referred to as a *step-up*.

Unlike the death benefit payable under a deferred annuity—a benefit that is never less than the greater of the net premiums paid and the cash value at death—the death benefit payable under an immediate life annuity or a life annuity settlement option is based solely on the presence of any minimum payment guarantee present in the contract. No death benefit is payable under a straight life annuity, however.

A consumer will normally prefer an investment under which guaranteed death benefits are payable over an otherwise identical investment not containing such a benefit. However, a consumer who has no family or other heirs and who is uninterested in leaving death benefit funds to a charity or other possible beneficiary would be unlikely to benefit from the death benefit provided under a deferred annuity.

2.1.4 Living Benefits

Guaranteed living benefits are secondary guarantees available under deferred variable annuity contracts. They provide minimum guarantees that offer some principal protection in the event the separate account investment performance has been poor.

Although not every insurer offers every guaranteed living benefit, four types of guaranteed living benefits (GLBs) are available. The GLBs are generally referred to as:

- Guaranteed minimum accumulation benefits (GMAB);
- Guaranteed minimum income benefits (GMIB);
- Guaranteed minimum withdrawal benefits (GMWB); and
- Guaranteed lifetime withdrawal benefits (GLWB).

GLBs are likely to be particularly attractive to consumers interested in participating in the potential gains available in the equity market but who wish to have some downside guarantees. Thus, if the cash value declines substantially because the selected variable subaccounts to which the consumer has allocated his or her premiums have performed poorly, the consumer may nonetheless receive a benefit.

A substantial concern affecting the use of GLBs concerns their cost and the effect of such costs on deferred variable annuity cash value growth. The annual cost for GLBs is equal to a percentage of the benefit base on which the benefit is calculated: for a GMAB benefit, the annual cost generally ranges from 55 basis points to 95 basis points; for a GMIB benefit, the annual cost ranges 90 basis points to 100 basis points; for a GMWB benefit, the annual cost ranges from 55 basis points to 85 basis points; and, for a GLWB benefit, the annual cost ranges from 85 basis points to 125 basis points. Although a single basis point is only 1/100th of a percent, the adverse effect on the cash value over an extended period of time may be quite significant.

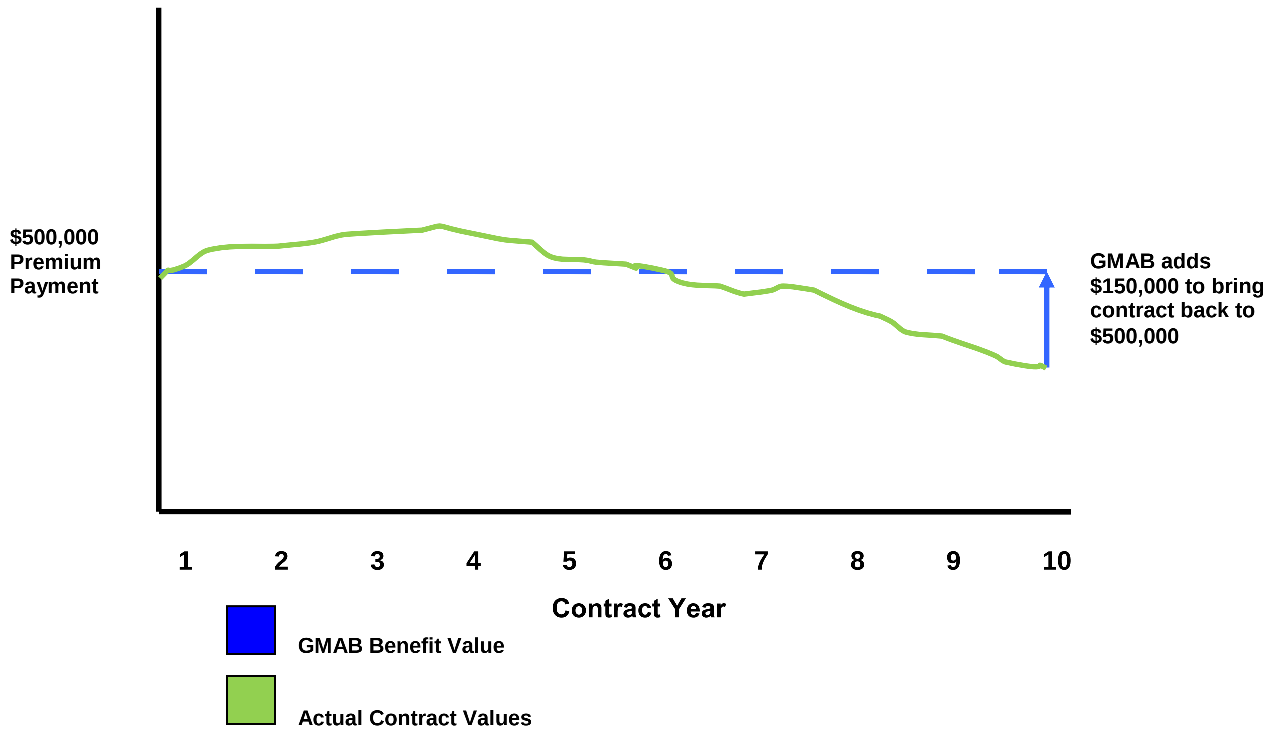
Let's look at the guarantees provided under each of the GLBs.

2.1.4.1 Guaranteed Minimum Accumulation Benefit

Under a guaranteed minimum accumulation benefit (GMAB), the insurer guarantees that if the deferred annuity's cash value is less than the GMAB benefit base—an amount typically equal to the consumer's first year premiums—at the end of the prescribed holding period, the insurer will increase the cash value up to equal the benefit base. The prescribed holding period is normally 8 to 10 years.

For example, suppose a consumer purchased a deferred variable annuity with a single premium of $500,000 and added a GMAB benefit. Because of poor investment performance of the variable subaccounts to which the consumer allocated the premiums, the contract value at the end of the 10-

year holding period had declined 30% to $350,000. Pursuant to the GMAB guarantee, the insurer would simply increase the cash value by $150,000 to equal the value of the benefit base. (See graphic below.)



2.1.4.2 Guaranteed Minimum Income Benefit

Unlike the lump-sum benefit available under a GMAB, the guaranteed minimum income benefit (GMIB) provides a benefit in periodic payments. Under a GMIB, the benefit is equal to the value of the GMIB benefit base annuitized as a fixed life annuity under very conservative annuity rates specified in the GMIB benefit provisions. The benefit base is equal to the net premiums paid during the holding period accumulated at a specified interest rate that may be 3% to 7%.

The annuity rates contained in the typical GMIB benefit provide a lower periodic payment per $1,000 annuitized than the current annuity rates available from the insurer. Accessing the benefit requires that the consumer have held the contract for the required holding period. The required holding period varies from insurer to insurer but is usually 8 to 10 years.

2.1.4.3 Guaranteed Minimum Withdrawal Benefit

A guaranteed minimum withdrawal benefit (GMWB) permits a consumer who purchased a deferred variable annuity containing the guarantee to make annual cash value withdrawals irrespective of the actual cash value until the total withdrawals equal the benefit base. (A GMWB benefit base is usually equal to the premium paid but may be increased by a "bonus" and reduced by withdrawals.)

Each of the maximum permitted annual withdrawals is equal to a percentage of the applicable GMWB benefit base. Thus even if the actual cash value has declined substantially, the consumer is still able to recover his or her premium payments. The permitted annual withdrawal amount may be equal to 5% - 10% of the benefit base, depending on the insurer's GMWB provisions.

For example, suppose a consumer purchased a deferred variable annuity with a single premium payment of $100,000, added a GMWB and never took a distribution from the annuity. Several years later the $100,000 initial cash value has declined to $30,000 because of poor investment performance, and the consumer elects to begin taking annual withdrawals under the GMWB. If the

GMWB provisions permit 7% annual withdrawals, the consumer could take $7,000 annual withdrawals until the entire $100,000 had been recovered regardless of the annuity's cash value.

2.1.4.4 Guaranteed Lifetime Withdrawal Benefit

The final guaranteed living benefit is known as a guaranteed lifetime withdrawal benefit (GLWB). Under a GLWB, a consumer who had purchased a deferred variable annuity containing the secondary guarantee could take annual withdrawals equal to a percentage of the applicable benefit base for life.

The annual percentage withdrawal under a GLWB is normally a few percentage points less than the permitted annual withdrawal under a GMWB. Accordingly, a contract owner would normally be able to take annual lifetime withdrawals equal to 3% to 5% of the GLWB benefit base. If the contract owner died before withdrawing an amount at least equal to the value of the benefit base, the difference would be paid to a beneficiary. However, if the contract owner withdrew an amount equal to the benefit base but continued to live, he or she could still take annual withdrawals based upon the applicable percentage of the benefit base for life.

2.2 Suitability Based on Consumer's Suitability Information

In addition for the requirement that the consumer benefit from one or more of certain annuity benefits, the annuity must also be suitable based on the consumer's suitability information that was gathered by the insurance producer. Accordingly, the annuity must be suitable:

- As a whole;
- With respect to the underlying variable subaccounts, if any, to which the consumer is allocating funds at the time of purchase or exchange;
- As to any riders or product enhancements; and
- With respect to any recommended exchange or replacement.

Let's examine what that annuity suitability requirement means.

2.2.1 Suitability of the Annuity as a Whole

When determining whether an annuity is suitable for the consumer, an insurance producer must consider all the relevant items of information that comprise the consumer's suitability information. In that regard, the relevant NAIC Suitability in Annuity Transactions model regulation text provides as follows:

> 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 shall have reasonable grounds for believing that … on the basis of the facts disclosed by the consumer … that there is a reasonable basis to believe … [t]he particular annuity as a whole… [is] suitable for the particular consumer based on his or her suitability information. (Section 6.A.(3))

Accordingly, the suitability analysis done by the producer should consider the consumer's:

- Age, and determine whether the consumer will be able to access the cash value to meet his or her objectives for which the annuity was purchased without surrender charges or tax penalties;
- Annual income, and determine whether the consumer's funding of a deferred annuity will adversely affect the consumer's ability to maintain his or her current lifestyle;
- Financial situation and needs, and determine whether the consumer's anticipated cash flow, current debt load, family obligations, existing financial resources, income and other financial obligations are likely to require that the consumer access the cash value to meet financial requirements and incur surrender charges and adverse tax treatment;
- Financial experience, and determine whether the consumer has sufficient investment experience and knowledge to be able to understand how to monitor variable subaccount values and manage variable subaccount volatility;
- Financial objectives, and determine whether the consumer's financial objectives are consistent with the characteristics and features of a deferred annuity and sufficiently long term to enable the consumer to avoid surrender charges and premature distribution tax penalties when accessing the annuity's cash value to meet them;

- Intended annuity use, and determine whether the use to which the consumer plans to put the annuity is appropriate, i.e. is the consumer's intended use to accumulate funds for and distribute them at retirement;
- Financial time horizon, and determine whether the consumer's objectives are sufficiently far into the future so that use of the annuity cash value is not required until the later of the consumer's age 59½ or the length of the surrender charge period;
- Existing assets, and determine whether the addition of a deferred annuity is appropriate in light of the consumer's asset composition and its ability to meet the individual's and family's financial needs;
- Liquidity needs, and determine whether the consumer's need for cash to meet his or her foreseeable expenses are likely to require the consumer to access the annuity's cash value and be exposed to surrender charges and tax penalties;
- Liquid net worth, and determine whether the total of the consumer's liquid net worth—the total value of savings accounts, cash and cash equivalents, publicly-traded stocks and bonds, and mutual funds—is sufficient to meet the consumer's identified liquidity needs;
- Risk tolerance, and determine whether the consumer's ability to tolerate volatility in the value of an investment, either financially or psychologically, would make a variable annuity unsuitable; and
- Tax status, and determine whether the consumer has a current income tax liability and the likelihood that the consumer's tax liability may be smaller at the time the annuity funds are distributed.

2.2.2 Initial Underlying Subaccounts must be Suitable

Not only must the annuity as a whole be suitable for a consumer based on his or her suitability information, the insurance producer's recommendation concerning a variable annuity's subaccounts to which the consumer initially allocates premiums must also be suitable. In that regard, the relevant NAIC Suitability in Annuity Transactions model regulation text provides as follows:

> 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 shall have reasonable grounds for believing that … on the basis of the facts disclosed by the consumer … that there is a reasonable basis to believe … the underlying subaccounts to which funds are allocated at the time of purchase or exchange of the annuity are suitable … for the particular consumer based on his or her suitability information. (Section 6.A.(3))

Determining the suitability of a variable annuity and the suitability of the allocation of initial premiums to its variable subaccount selection requires that the consumer's risk tolerance level be determined. The insurance producer has no suitability requirement as to asset allocation to the variable subaccounts other than at the time of initial premium allocation.

We noted earlier that, as part of gathering the required consumer suitability information, an insurance producer must obtain sufficient information to determine the consumer's risk tolerance, i.e. the amount of volatility in an investment's value the consumer can tolerate. In making that determination, it is important to bear in mind that a consumer's risk tolerance has both a financial component and a psychological one.

2.2.2.1 Risk Tolerance Suitability Factors

The factors that need to be considered in assessing the level of acceptable investment volatility when performing a suitability analysis for any consumer are his or her:

- Total investment assets because financial tolerance for risk normally increases as a consumer's wealth increases;
- Financial time horizon because the ability to recover from an investment loss and still meet the goal increases—as does the consumer's financial risk tolerance—if the goal is more distant in time;
- Other financial responsibilities because the possible need for cash to meet other responsibilities—responsibilities to family members, colleagues or others—can be expected to reduce a consumer's psychological and financial tolerance of a severe loss of an investment's

value. Thus, a consumer with other financial responsibilities is less likely to have a high risk tolerance; and

- Psychological make-up because a consumer who is highly risk-averse and cannot bear the thought of losing money in an investment is intolerant of risk, despite the extent of investment assets, an extended financial time horizon and the lack of other financial responsibilities; exposing such an individual to investment risk is unsuitable.

Although advisers may fine tune the process of risk assessment and identify additional gradations of tolerance, risk tolerance may be:

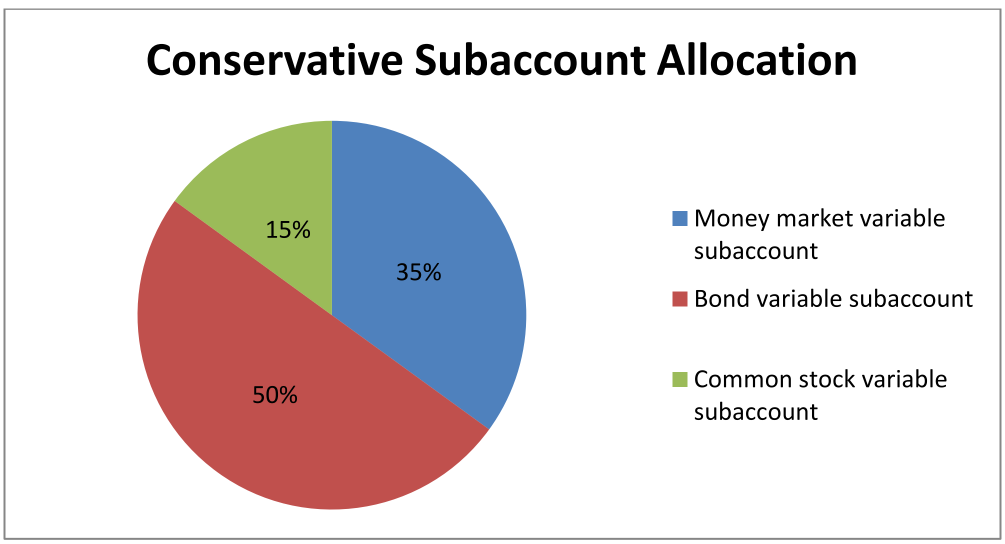
- Conservative;
- Moderate; or
- Aggressive.

2.2.2.1.1 Conservative Risk Tolerance

A consumer's risk tolerance is generally considered conservative if his or her principal concern is capital preservation. Such a consumer has a low tolerance for possible investment loss, even if temporary. Instead, a consumer who is a conservative investor typically seeks investment price stability and capital preservation.

Assuming that a variable annuity, with its generally-higher expenses compared to a fixed annuity, is suitable overall for the consumer, the suitable allocation of funds to the variable annuity's subaccounts should normally be heavily weighted towards cash equivalents and fixed income investments. Only a modest allocation of funds to common stocks should be made.

Thus, a suitable initial allocation of funds to variable subaccounts for a consumer with a conservative risk tolerance should normally be heavily weighted towards the bond variable subaccount and approximate the allocation shown in the graphic below:

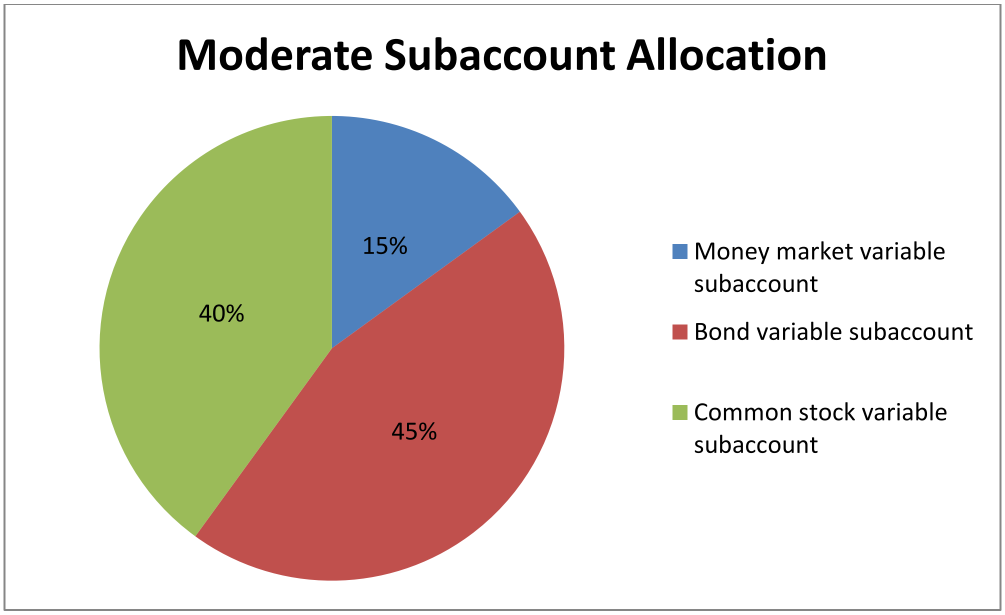


A deferred variable annuity is generally unsuitable for a consumer whose risk-aversion is so strong that he or she plans to allocate all premiums and cash values to a deferred variable annuity's fixed account. A suitable deferred fixed annuity should normally be recommended instead of a variable annuity in such a case.

2.2.2.1.2 Moderate Risk Tolerance

A consumer's risk tolerance is generally considered to be moderate—neither particularly conservative nor aggressive—if the consumer is will to accept the possibility of some principal loss in order to achieve potentially higher returns. A consumer whose risk tolerance is moderate generally seeks to maintain a balance between income-oriented investments and growth-oriented investments.

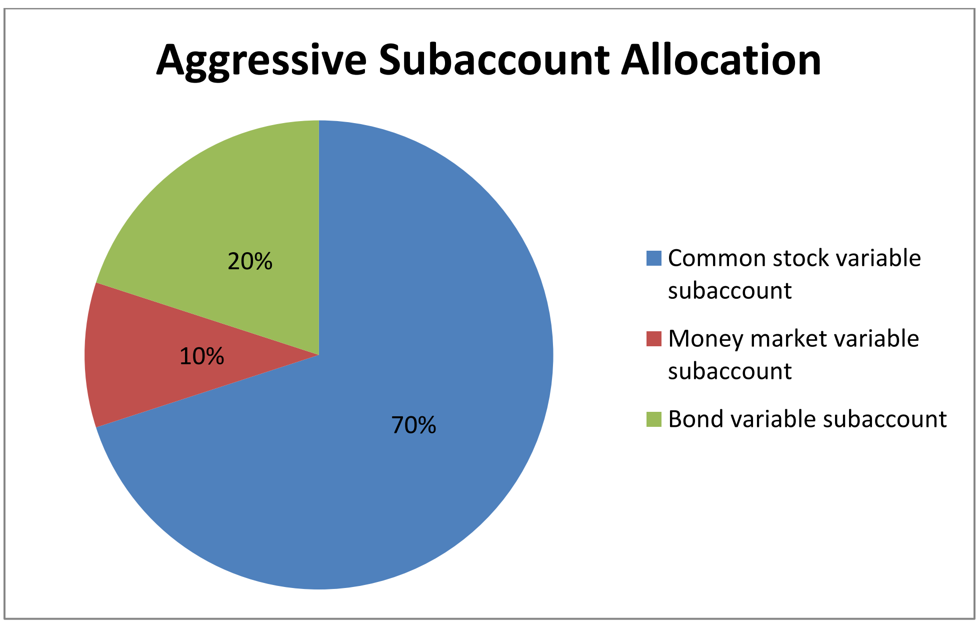
The suitable initial allocation of funds to variable subaccounts for a consumer with a moderate risk tolerance should normally approximate the allocation shown in the following graphic:



2.2.2.1.3 Aggressive Risk Tolerance

An investor who is generally focused on outperforming the market and willing to bear substantial risk in order to do so has an aggressive risk tolerance. A suitable asset allocation for a consumer with an aggressive risk tolerance is heavily weighted towards common stocks, particularly small cap and growth stocks.

A suitable initial variable subaccount premium allocation for a consumer who is an aggressive investor and has a commensurate risk tolerance usually should be heavily weighted towards a common stock allocation and look as indicated in the following graphic:



2.2.3 Riders and Enhancements must be Suitable

In a technical sense, a rider is simply an addition to an insurance contract that expands or limits the coverage provided under the contract to which it is attached. As the term is used in connection with the suitability of an annuity, however, a rider refers to an additional benefit that is provided and for which an additional premium cost is usually imposed.

Riders and product enhancements that may be added to an annuity contract include:

- Long term care insurance riders that offer benefits for a contract owner's covered long term care;
- Additional death benefit riders that offer a rollup or step-up death benefit on variable annuity contracts;
- Inflation riders that increase periodic payments over time in order to maintain purchasing power despite the adverse effects of inflation;
- Living benefit riders available on variable annuities that provide secondary guarantees; and
- Crisis waiver riders that waive surrender charges upon the occurrence of specified "crises," such as diagnosis of a terminal illness or need for long term care.

An insurance producer is expected to consider the suitability of any riders or product enhancements in his or her suitability analysis. Such benefits should be recommended only when they are suitable for the consumer. The relevant NAIC Suitability in Annuity Transactions model regulation text speaks to the requirement for rider suitability as follows:

> 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 shall have reasonable grounds for believing that … on the basis of the facts disclosed by the consumer … that there is a reasonable basis to believe … [t]he … riders and similar product enhancements, if any, are suitable for the particular consumer based on his or her suitability information. (Section 6.A.(3))

Accordingly, rider recommendations would normally be suitable as follows:

- Recommendation of a long term care insurance rider would be suitable if the consumer's long term care risk was not satisfied through other coverage, the consumer's assets were at least $35,000 and the cost of the rider did not exceed 7% of the consumer's income;
- Recommendation of an additional death benefit rider would be suitable if the consumer was concerned that annuity death benefits be maximized for his or her beneficiary;
- An inflation rider recommendation would be suitable if the consumer was receiving periodic payments and was concerned about insuring against purchasing power risk;
- Recommendation of a living benefit rider would be suitable if the consumer wanted to purchase a deferred variable annuity, expressed interest in providing for some principal protection and accepted the possibly significant drag on cash value accumulation the benefit cost created; and
- Recommendation of a crisis waiver rider would be suitable if the consumer's other available assets were expected to be insufficient to meet the consumer's financial needs following the occurrence of a specified crisis for which the surrender charges would be waived.

2.2.4 Suitability of Exchange or Replacement

The insurance industry frequently introduces new products and additional enhancements to existing products. Annuity contract owners are sometimes eager to enjoy these newly-introduced benefits and, as a result, may seek to replace or exchange existing annuity contracts for other annuity contracts.

An annuity replacement may be appropriate or not, depending on the situation. While existing annuity contract owners are free to replace their annuities for other annuities, regardless of the suitability of such a replacement, insurance producers recommending an annuity replacement or exchange must ensure that any recommended replacement or exchange is suitable for the consumer based on his or her suitability information.

2.2.4.1 Annuity Replacement

A simple annuity replacement generally involves the surrender of an existing deferred annuity contract and the issuance of a new annuity contract. Upon surrender of the existing contract, the contract owner receives the insurer's check for the surrender proceeds, and all gain that was deferred is taxable as ordinary income in the year of the surrender. If the contract owner is younger than age 59 ½ and no exception to the premature distribution tax penalty applies, the gain includible in the contract owner's income is subject to an additional 10% tax penalty.

If the replacement is made during the existing annuity's surrender charge period, a surrender charge may also be imposed. Not surprisingly, a deferred annuity replacement that is not made pursuant to IRC §1035 may be very expensive for a deferred annuity contract owner.

The actual surrender of an existing annuity and the sale of another annuity to take its place would certainly constitute a replacement. However, the definition of a replacement under the NAIC Suitability in Annuity Transaction model regulation is far broader than that.

Under the model regulation, an annuity "replacement" means a transaction in which a new annuity contract is to be purchased, and it is known or should be known to the proposing producer that by reason of the transaction, an existing policy or contract has been or is to be:

- Lapsed, forfeited, surrendered or partially surrendered, assigned to the replacing insurer or otherwise terminated;
- Converted to reduced paid-up insurance, continued as extended term insurance, or otherwise reduced in value by the use of nonforfeiture benefits or other policy values;
- Amended so as to effect either a reduction in benefits or in the term for which coverage would otherwise remain in force or for which benefits would be paid;
- Reissued with any reduction in cash value; or
- Used in a financed purchase.

2.3 Exchange or Replacement Suitability Analysis

Rather than face the often substantial expense associated with an annuity replacement, an annuity contract owner may exchange his or her annuity pursuant to a tax-free exchange permitted under IRC §1035. Under a §1035 exchange, an annuity contract owner may exchange an annuity contract for another annuity contract or a qualified long term care insurance contract.

If the §1035 exchange involves the exchange of an annuity contract for a different annuity contract (rather than a long term care insurance contract), a fixed annuity contract may be exchanged for a fixed annuity or for a variable annuity contract. Similarly, a variable annuity contract may be exchanged for a different variable annuity contract or for a fixed annuity contract. If an annuity is exchanged for another annuity, the contracts must be payable to the same person or persons in order to qualify as a tax-free exchange under IRC §1035.

2.3.1 IRC §1035 Carryovers

Under a §1035 tax-free exchange, the deferred annuity contract owner's cost basis in the exchanged annuity becomes the owner's cost basis in the annuity contract issued pursuant to the exchange. Furthermore, the tax-deferred gain under the original annuity is carried over to the new annuity. Thus, from an income tax perspective the consumer is in the same place in the new annuity contract as he or she was under the original annuity contract.

Deferred annuities issued before August 14, 1982 enjoy the favorable tax treatment of cash value withdrawals that is characteristic of withdrawals from a life insurance policy, a tax treatment known as first in first out (FIFO). Under FIFO tax treatment, cash value withdrawals are tax-free as a recovery of the contract owner's cost basis until all cost basis has been recovered. Only after all cost basis has been recovered are further withdrawals deemed to be comprised of taxable gain. That favorable tax treatment is carried over to the new annuity contract issued under a §1035 tax-free exchange.

2.3.2 Certain Tax Benefits not Carried Over in Exchange

Although IRC §1035 tax-free exchanges enable a deferred annuity contract owner to carry over the original annuity's cost basis, maintain the tax-deferral of gain and continue to enjoy FIFO tax treatment of distributions (if the exchanged annuity was issued before August 14, 1982), certain other tax benefits are not carried over to the new contract. Those tax benefits that are not carried over concern:

- The former step-up of the annuity's basis; and
- Tax-deferral for non-natural annuity owners.

2.3.2.1 Step-up in Basis Lost

Many types of property when received by a beneficiary following the death of the owner receive a step-up in basis in the hands of the beneficiary. When the beneficiary subsequently disposes of the property, the beneficiary's cost basis in the property is equal to the property's value at the time of the original owner's death.

For example, suppose Bob owned undeveloped land that he purchased decades ago for $50,000. Over the years the land increased in value and, at the time of Bob's death, the still-undeveloped land was valued at $500,000. Bob bequeathed the land to his friend Catherine at his death. When she sold the land six months later and received a sale price of $500,000, she had no taxable income to recognize since her cost basis in the property was "stepped-up" to $500,000, i.e. the value of the land when Bob died.

Deferred annuities issued before October 21, 1979 were subject to the same kind of step-up in basis upon the death of a deferred annuity contract owner. Accordingly, the deferred annuity beneficiary did not have to recognize any income on the annuity value received on the contract owner's death. That step-up in basis ceased for deferred annuity contracts issued on and after October 21, 1979. Furthermore, the favorable step-up in basis characteristic of a deferred annuity contract issued before October 21, 1979 and subsequently exchanged under IRC §1035 is not carried over to the new deferred annuity contract issued under the exchange.

2.3.2.2 Non-natural Owner Tax-deferral Lost on Exchange

One of the important benefits of deferred annuity ownership relates to the tax-deferral of gain until the gain is distributed. That characteristic tax-deferral was enjoyed by all annuity owners before February 28, 1986. However, that changed on February 28, 1986.

With certain exceptions, non-natural deferred annuity owners—corporations and certain other owners that are not natural persons—no longer enjoyed the tax benefits normally associated with deferred annuities to the extent that contributions were made after February 28, 1986. Instead, income on the contract owned by a non-natural person is treated as ordinary income received by the owner during the taxable year.

Because of that change in the law, non-natural deferred annuity owners subject to the new rules generally ceased making contributions to the contracts. Such contracts owned by non-natural persons to which no further contributions were made continued to be taxed under the annuity rules, i.e. they retained their characteristic tax-deferral

If a deferred annuity contract owned by a non-natural person is replaced or exchanged—even under an IRC §1035 exchange—the tax-deferral of gain is lost unless an exception applies. The exceptions to the loss of tax-deferral because of non-natural person ownership apply to a deferred annuity contract:

- Acquired by a deceased owner's estate due to the owner's death;
- Held under certain qualified retirement plans;
- Owned by an employer to facilitate the payment of qualified plan participant benefits following the plan's termination; or
- That is a qualified funding asset.

2.3.3 Surrender Charges on Replaced Annuity

As noted earlier, surrender charges are charges imposed by an insurer on deferred annuity cash value withdrawals in excess of any surrender-charge free amount and on a complete surrender of an annuity contract during the surrender charge period. Surrender charges are designed to enable the insurer to recover any unrecovered business acquisition charges. Annuity surrender charge periods generally vary in duration from five years to fifteen years.

The NAIC Suitability in Annuity Transactions model regulation provides with respect to surrender charges in connection with a replacement or exchange of an annuity that:

> In recommending to a consumer … the exchange of an annuity that results in another insurance transaction or series of insurance transactions, the insurance producer shall have reasonable grounds for believing that … on the basis of the facts disclosed by the consumer … that there is a reasonable basis to believe … [i]n the case of an exchange or replacement of an annuity, the exchange or replacement is suitable including taking into consideration whether… [t]he consumer will incur a surrender charge [or] be subject to the commencement of a new surrender period. (Section 6.A.(4)(a))

The imposition of a surrender charge by the replaced insurer does not necessarily mean that replacement or exchange of the annuity is unsuitable for the consumer. However, its imposition and amount must be given due consideration in an insurance producer's suitability analysis relative to annuity replacement or exchange.

2.3.4 Surrender Charges on Replacement Annuity

Just as the presence of a surrender charge under an existing annuity needs to be considered in assessing the suitability of its replacement or exchange, the consumer's becoming subject to a new surrender charge period under the deferred annuity issued on replacement must also enter into an insurance producer's suitability analysis. If the replacing insurer offers a "bonus" on the new deferred annuity contract, the additional interest crediting that is characteristic of the bonus increases the insurer's business acquisition expenses. The additional business acquisition expenses in such a case often result in increased surrender charges and a lengthened surrender charge period under the replacement annuity.

Depending on the age of the existing annuity and the duration of any surrender charge period, a contract owner may no longer be subject to a surrender charge under the existing annuity contract. A consumer who replaces the annuity is likely to be faced with new surrender charges that further limit the investment's liquidity.

2.3.5 Loss of Existing Benefits

In addition to the loss of certain grandfathered tax benefits discussed earlier—the step-up in basis and more favorable non-natural owner tax treatment—the replacement or exchange of a deferred annuity may result in the loss of benefits provided under the annuity. The NAIC Suitability in Annuity Transactions model regulation provides with respect to the possible loss of existing benefits on a replaced annuity that:

> In recommending to a consumer … the exchange of an annuity that results in another insurance transaction or series of insurance transactions, the insurance producer shall have reasonable grounds for believing that … on the basis of the facts disclosed by the consumer … that there is a reasonable basis to believe … [i]n the case of an exchange or replacement of an annuity, the exchange or replacement is suitable including taking into consideration whether… [t]he consumer will … lose existing benefits. (Section 6.A.(4)(a))

Principal among the annuity benefits that would be lost on its replacement or exchange are:

- Enhanced death benefits; and
- Guaranteed living benefits.

Since the impetus to replace or exchange an existing deferred variable annuity contract may be the result of poor investment experience, any such replacement of a deferred variable annuity containing an enhanced death benefit or a guaranteed living benefit is likely to result in a loss of benefits either to the contract owner or beneficiary. Let's briefly consider each of these potentially lost benefits.

2.3.5.1 Enhanced Death Benefits may be Lost

The enhanced death benefits that may be available under a variable annuity—additional benefits pursuant to death benefit step-up and rollup provisions—were examined earlier. These additional death benefits are lost when the variable annuity is replaced or exchanged.

Under a death benefit rollup, the enhanced death benefit is based on the greater of the annuity premium accumulated at interest—usually at a 3% - 5% interest rate—or the cash value at death. Thus, even if the cash value declined in value, the consumer's beneficiary would receive a death benefit equal to the premium accumulated at interest.

Under a death benefit step-up, the enhanced death benefit is based on the greater of a) the net premiums paid, or b) the greater of the cash value on the date of death or on specified anniversaries. In other words, a step-up death benefit "captures" a high-water death benefit. Thus, if the cash value subsequently declines due to poor investment results, the beneficiary will, nonetheless, receive a death benefit based on the higher of the net premiums or the "captured" cash value.

If a consumer replaces or exchanges his or her current deferred annuity that contains a rollup or step-up enhanced death benefit the possible loss of death benefits by the consumer's beneficiary needs to be considered in assessing the suitability of the replacement or exchange.

2.3.5.2 Guaranteed Living Benefits may be Lost

In addition to the possible loss of enhanced death benefits on the replacement or exchange of a deferred annuity, the guarantees under the various guaranteed living benefits would be lost. As discussed earlier, the guaranteed living benefits under a deferred variable annuity may be:

- Guaranteed minimum accumulation benefits, under which a contract owner is guaranteed to receive an amount at least equal to his or her net premiums at the end of an 8 – 10 year holding period;
- Guaranteed minimum income benefits, under which a contract owner may annuitize the amount of a hypothetical benefit base as periodic payments for life at the end of an 8 – 10 year holding period;
- Guaranteed minimum withdrawal benefits, under which a contract owner is guaranteed to be able to recover his or her net premiums through annual cash value withdrawals equal to 5% to 10% of a hypothetical benefit base; and
- Guaranteed lifetime withdrawal benefits, under which a contract owner is guaranteed to be able to take annual lifetime withdrawals, usually equal to 3% to 5% of a hypothetical benefit base.

The suitability analysis performed by an insurance producer in the event of replacement or exchange of a deferred variable annuity containing a guaranteed living benefit—a benefit that could enable the consumer to recover some or all of his or her net premiums—must consider the loss of that guarantee.

2.3.6 Increases in Fees and Other Charges

A consumer's decision to replace or exchange an existing deferred annuity may be based on his or her anticipated ability to enjoy new and/or increased benefits. Even though insurers may choose to provide those increased benefits at no cost, few insurers are likely to do so. In other words, new or enhanced benefits generally are accompanied by increased costs.

The possible increased fees imposed on the consumer under the annuity contract issued on replacement or exchange is addressed in the NAIC Suitability in Annuity Transactions model regulation, which provides as follows:

> In recommending to a consumer … the exchange of an annuity that results in another insurance transaction or series of insurance transactions, the insurance producer shall have reasonable grounds for believing that … on the basis of the facts disclosed by the consumer … that there is a reasonable basis to believe … [i]n the case of an exchange or replacement of an annuity, the exchange or replacement is suitable including taking into consideration whether… [t]he consumer will … be subject to increased fees, investment advisory charges for riders and similar product enhancements. (Section 6.A.(4)(a))

When performing the suitability analysis required before recommending an annuity replacement or exchange, an insurance producer must identify and consider any increased expenses that will be passed along to the consumer. Such costs include increased M&E risk fees, investment advisory fees, maintenance and recordkeeping charges and additional charges for any riders or product enhancements that are part of the replacement annuity.

2.3.7 Ability to Benefit from Product Enhancements

Few factors that must be considered in the suitability analysis that precedes an annuity replacement or exchange recommendation—when considered alone—are likely to cause the recommendation to be deemed unsuitable. The consumer's ability to benefit is an exception. If an annuity replacement or exchange recommendation is based solely on the product enhancements contained in the replacement annuity, the consumer must be able to benefit from them in order for the recommendation to be suitable. Thus, if the consumer is unable to benefit from any of the product enhancements contained in the replacement annuity, the *replacement is unsuitable for the consumer*.

The requirement that the consumer would benefit is also addressed in the NAIC Suitability in Annuity Transactions model regulation, which provides that:

> In recommending to a consumer … the exchange of an annuity that results in another insurance transaction or series of insurance transactions, the insurance producer shall have reasonable grounds for believing that … on the basis of the facts disclosed by the consumer … that there is a reasonable basis to believe … [i]n the case of an exchange or replacement of an annuity, the exchange or replacement is suitable including taking into consideration whether… [t]he consumer would benefit from product enhancements and improvements. (Section 6.A.(4)(b))

2.3.8 Multiple Exchanges or Replacements

Repeated annuity exchanges or replacements are not, of themselves, unsuitable. Instead, multiple exchanges or replacements and the costs, surrender charges and other factors associated with them that can negatively impact a consumer suggest that an insurance producer may not be acting in the consumer's best interest.

Thus, in the case of an exchange or replacement of an existing annuity, the insurance producer must consider in his or her suitability analysis whether the consumer has had another annuity exchange or replacement, particularly one within the preceding 36 months.

2.4 Mitigation of the Suitability Obligation

An insurer must not issue an annuity contract recommended to a consumer unless it has a reasonable basis to believe the annuity is suitable based on the consumer's suitability information. However, although an insurer's issuing of an annuity contract must be reasonable in light of the circumstances known by the insurer at the time the contract was issued, neither the insurer nor the insurance producer has a suitability obligation in certain cases.

No suitability obligation to a consumer exists under the NAIC Suitability in Annuity Transactions model regulation, other than the obligation to make reasonable efforts to obtain the consumer's suitability information, if any of the following applies:

- No recommendation is made;
- A recommendation was made based on information provided by the consumer that was subsequently found to materially inaccurate;
- The consumer refuses to provide relevant suitability information and no annuity transaction is recommended; or
- The consumer enters into an annuity transaction that is not based on the insurance producer's recommendation.

2.5 Required Documentation

Insurance producers, at the time of the sale of an annuity, must meet certain documentation requirements under the model regulation[5]. At the time of sale, the producer is required to do the following:

- Make a record of any recommendation subject to the suitability requirements;
- If the consumer refuses to provide suitability information, to obtain a statement, signed by the consumer, documenting his or her refusal to provide suitability information; and
- 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.

2.6 Insurers Must Supervise

Insurers are required to establish a supervision system reasonably designed to achieve compliance with the model regulation. The supervision system must include, but is not limited to, the following:

- Insurers must maintain reasonable procedures to inform producers of the requirements of the regulation and are required to incorporate its requirements into appropriate insurance producer training manuals;

[5] NAIC Suitability in Annuity Transactions model regulation. Section 6.E.

- Insurers must establish standards for producer product training and maintain procedures requiring producers to comply with the regulation's insurance producer training requirements (See **Training Requirements** below);
- Insurers must provide product-specific training and training materials that explain all material features of their annuity products to producers;
- Insurers must maintain procedures for the review of each recommendation before issuing an annuity in order to ensure there is a reasonable basis to determine that a recommendation is suitable;
- Insurers must maintain procedures to detect unsuitable recommendations; and
- Insurers are required annually to provide a report to their senior management detailing a review to determine the effectiveness of the supervision system.

Insurance producers are prohibited from dissuading or attempting to dissuade a consumer from responding truthfully to an insurer's request for confirmation of suitability information, filing a complaint or cooperating with the investigation of a complaint.

2.6.1 Subcontracting Supervision Activities

An insurer is permitted to subcontract the activities required under its supervision responsibilities, including the required maintenance of procedures. However, irrespective of the insurer's subcontracting of required supervision activities, the insurer remains responsible for taking any needed and appropriate corrective action.

Additionally, an insurer who has subcontracted the supervision activities required under the model regulation nonetheless retains responsibility for oversight. Pursuant to that oversight responsibility, the insurer must:

- Monitor and conduct audits, as appropriate, to ensure that the contracted supervisory function is being properly performed; and
- Obtain an annual certification from a senior manager responsible for the subcontracted function that the supervision function is being properly.

2.7 Training Requirements

Insurance producers are not permitted to solicit the sale of annuity products unless they have adequate knowledge of the product to recommend the annuity and are in compliance with the insurer's standards for product training. Accordingly, insurance producers must meet the following training requirements:

- An insurance producer who engages in the sale of annuity products must complete a one-time four (4) credit training course approved by the department of insurance and provided by an approved education provider;
- The required training must include information concerning –
    - The types and classifications of annuities,
    - Parties to an annuity,
    - How fixed, variable and indexed annuity contract provisions affect consumers,
    - The application of income taxation qualified and nonqualified annuities,
    - The primary uses of annuities, and
    - Appropriate sales practices, replacement and disclosure requirements.

Section Review

2.8 Section Review

1. Arthur paid $100,000 for a deferred variable annuity containing a guaranteed minimum accumulation benefit. Because of poor investment performance, the annuity cash value at the end of the GMAB required holding period was $80,000. What benefit is payable under the GMAB?

    A. $0

    B. $20,000

C. $80,000

D. $100,000

2. Barbara properly identified the consumer's risk tolerance and made a recommendation for a suitable initial allocation of premiums to the annuity's variable subaccounts. How frequently must she review the contract owner's variable subaccount selection to ensure it remains suitable?

   A. Every year

   B. Every 2 years

   C. Every 5 years

   D. No further suitability requirements apply

3. Phyllis paid $100,000 for her deferred annuity and exchanged it ten years later under IRC §1035 when its cash value was $130,000. Assuming she has never taken a distribution from the annuity, how much income will she be required to recognize on the exchange transaction?

   A. $0

   B. $30,000

   C. $100,000

   D. $130,000

4. Which of the following benefits is/are carried over from the replaced annuity to the replacement annuity in an IRC §1035 exchange?

   I. Enhanced death benefits

   II. Guaranteed living benefits

   A. I only

   B. II only

   C. Both I & II

   D. Neither I nor II

5. Alan's customer wanted to purchase an annuity, but the consumer refused to share any suitability information with him. What is Alan required to do under the NAIC Suitability in Annuity Transactions model regulation?

   A. Notify the insurance regulator of the consumer's refusal to provide suitability information

   B. Limit the sale only to a fixed annuity

   C. Obtain a signed statement from the consumer documenting the consumer's refusal to provide suitability information

   D. Refuse to sell the annuity to the consumer

3.0 Disclosure Requirements

In addition to obtaining the various items of information that comprise a consumer's suitability information and determining the suitability of any annuity transaction in light of that gathered information, an insurance producer has certain disclosure requirements. Pursuant to the requirements of the NAIC Suitability in Annuity Transactions model regulation, an insurance producer recommending the purchase or exchange of an annuity must have a reasonable basis to believe that the consumer has been informed of various annuity features.

Among the annuity features concerning which the consumer must be reasonably informed are the following:

- The potential surrender period and surrender charge;
- The potential tax penalty if the consumer sells, exchanges, surrenders or annuitizes the deferred annuity;
- The mortality and expense (M&E) risk charges and investment advisory fees that may be imposed;
- The potential charges for and features of recommended riders;
- The existence of any limitation on interest crediting;
- The annuity's insurance and investment components; and
- The market risk to which the recommended annuity transaction may expose the consumer.

As stated in the model regulation:

> 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 the insurer where no producer is involved, shall have reasonable grounds for believing …that there is a reasonable basis to believe … [t]he 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. (Section 6.A.(1)

Since the insurance producer must reasonably believe the consumer has been informed concerning these features, the insurance producer has a corresponding duty to make the necessary, detailed disclosures. Let's consider each of these required disclosures.

3.1 Potential Surrender Period and Charges

As noted earlier, an insurer's imposition of surrender charges is related directly to its expenditure of funds in order to acquire the business. Depending upon the type of insurance product involved, insurers' business acquisition expenses may be quite substantial. In some cases, the business acquisition expenses actually exceed the insurer's first-year revenue from the particular piece of business.

Insurers routinely recover their business acquisition expenses under annuity contracts that remain in force in two ways:

- Through sales charge deductions from premiums before being credited to the annuity cash value, a characteristic of front-end loaded contracts; and
- Through periodic deductions from the annuity's cash value.

In order to ensure that the insurer will be able to recover its business acquisition expenses in the event the deferred annuity is surrendered, the insurer imposes surrender charges. These surrender charges apply only during the annuity contract's surrender charge period.

The duration of the surrender charge period is equal in length to the period of time over which the insurer would routinely recover its business acquisition expenses through regular deductions. Since unrecovered business acquisition expenses generally decline as the annuity contract remains in force and the insurer makes its regular deductions, the corresponding surrender charge percentage normally declines over the surrender charge period as well until it reaches 0% at the conclusion of the surrender charge period.

It is not unusual for an insurer's surrender charge provision to impose surrender charges that decline over the surrender charge period, in a manner similar to the chart below:

Contract Year	1	2	3	4	5	6	7	8	9	10	11 & later
Surrender Charge	10%	9%	8%	7%	6%	5%	4%	3%	2%	1%	0%

When an insurer offers a consumer additional incentives to purchase, replace or exchange an annuity—such as bonus interest credits, for example—the insurer's business acquisition expenses are normally increased, usually by an amount equal to the additional incentive. Because of those increased business acquisition expenses the surrender charge provision may change dramatically. The surrender charge provision in a flexible premium deferred annuity under which the insurer provided a substantial bonus could extend for as many as fifteen years and have a first-year surrender charge of 20%.

An insurance producer recommending a transaction, i.e. the purchase, replacement or exchange, of an annuity under which the insurer imposes a surrender charge must have a reasonable basis to believe the consumer is appropriately informed concerning the surrender provision. An appropriate surrender charge provision disclosure would normally include a disclosure of:

- The duration of the surrender charge period;
- The extent of the surrender charge imposed for a surrender in each of the years of the surrender charge period; and
- The types of distributions and circumstances—permitted surrender charge-free annual withdrawals and conditions under which crisis waivers would waive applicable surrender charges—under which surrender charges would not be imposed.

3.2 Annuity Tax Treatment

An insurance producer recommending the purchase or exchange of an annuity to a consumer must disclose the tax treatment to which the annuity is subject. In addition, the disclosure should address potential tax penalties.

Distributions from an annuity are classified as either a) amounts received as an annuity, or b) amounts not received as an annuity. Periodic payments are considered *amounts received as an annuity* and are taxed under a regimen designed to return the purchaser's investment in the contract in equal tax-free amounts over the payment period, the balance of such payments being taxable as ordinary income. When the cost basis has been completely recovered, all remaining periodic payments are fully taxable. In contrast, annuity distributions—a category that includes cash value withdrawals, loans and partial surrenders—are considered *amounts not received as an annuity*.

As discussed earlier, such amounts not received as an annuity are subject to unfavorable LIFO tax treatment and possible tax penalties. The tax penalty for amounts not received as an annuity by contract owners younger than age 59 ½ is equal to 10% of the amount includable in income.

In addition to informing the consumer generally about the tax treatment of annuities, an insurance producer must also disclose the tax treatment if the consumer:

- Takes a cash value withdrawal under the annuity;
- Borrows using the annuity as collateral;
- Sells the annuity;
- Gives the annuity away;
- Exchanges the annuity;
- Surrenders the annuity; or
- Annuitizes the annuity.

Let's examine the information that should be provided.

3.2.1 Cash Value Withdrawals from an Annuity

Cash value withdrawals and other distributions from a nonqualified annuity receive last in first out (LIFO) tax treatment under which all taxable gain—the annuity's cash value in excess of the contract owner's net premiums, in other words—is deemed to be distributed before any tax-free cost basis is deemed distributed. (Cost basis in a nonqualified annuity is equal to the contract owner's aggregate net premiums.)

For example, a nonqualified deferred annuity for which a contract owner paid $100,000 in total premiums and from which no distributions were ever taken has a cost basis of $100,000. If that deferred annuity's cash value were $130,000, the annuity would have a gain of $30,000. ($130,000 - $100,000 = $30,000) If the annuity contract owner took a $35,000 cash value withdrawal, the withdrawal would be deemed to consist of $30,000 in taxable gain and $5,000 in a tax-free recovery of cost basis. The $30,000 gain received by the contract owner is taxable as ordinary income in the year in which the withdrawal was made. The $5,000 recovery of the contract owner's cost basis is received entirely tax-free. The contract owner's tax-free recovery of the $5,000 cost basis reduces the contract owner's cost basis from $100,000 to $95,000. ($100,000 - $5,000 = $95,000)

If there is no gain on the nonqualified deferred annuity contract—if the cash value is less than the contract owner's cost basis, in other words—no taxable income would be distributed in a deferred annuity withdrawal, and no tax penalty would apply.

3.2.2 Annuity Loans

A nonqualified deferred annuity contract owner may pledge or assign an annuity contract for a loan. Regardless of whether the annuity loan is made by the insurer or made by a lending institution and secured by the annuity's pledged cash value, the amount received is considered a distribution from the annuity and the lesser of the gain or the loan is taxed as an amount not received as an annuity. In other words, the amount received as an annuity loan is taxed in the same way the cash value withdrawal is taxed. Accordingly, it is subject to unfavorable LIFO tax treatment and possible tax penalties if the contract owner is younger than age 59 ½.

For example, suppose a nonqualified deferred annuity contract owner paid $50,000 in total premiums for the annuity and had never previously taken a distribution. If the contract owner took a $7,000 annuity loan by pledging the annuity's $55,000 cash value as collateral, the contract owner would be deemed to have received $5,000 in a taxable distribution and $2,000 as a tax-free recovery of cost basis. The $5,000 taxable distribution is considered ordinary income. The $2,000 tax-free recovery of cost basis reduces the contract owner's cost basis for any subsequent distribution.

3.2.3 Sale of the Annuity

A nonqualified deferred annuity contract owner may dispose of the annuity by selling it to another person. If an annuity is sold, the excess of the cash surrender value over the contract owner's cost basis in the contract is taxed as ordinary income to the selling contract owner. If the selling contract owner is younger than age 59 ½ and no exception to the premature distribution penalty tax applies, the amount included in income is subject to a 10% tax penalty.

It is possible that a nonqualified deferred annuity contract owner may be able to sell the annuity contract to another person for a price in excess of the annuity's cash value, particularly if a secondary guarantee under the contract—a guaranteed living benefit, in other words—may eventually guarantee an amount to the contract owner in excess of the cash value. In such a case, it is unclear how the tax code would tax the amount of sale proceeds in excess of the cash value, i.e. as ordinary income or capital gains. However, the portion of the sale proceeds represented by the cash value in excess of the owner's cost basis on the date of the sale would be considered ordinary income.

If the contract owner sells a nonqualified deferred annuity for less than the annuity's cash value, the amount of the cash value in excess of the sale price is considered a gift. (See **Gift of the Annuity** below.)

3.2.4 Gift of the Annuity

A nonqualified deferred annuity contract owner may give the annuity contract away to another person. Such a transaction is considered, for purposes of taxation, to be a "transfer without adequate consideration."

An individual who transfers a nonqualified annuity contract issued after April 22, 1987 for less than adequate consideration—unless the transfer is between spouses or incident to a divorce—is treated as having received as a taxable distribution the amount by which the cash value on the date of the gift exceeds the cost basis. In other words, if the contract owner makes a gift of the annuity, he or she must recognize the gain on the annuity as ordinary income in the year in which the gift is made. In contrast, the transfer of ownership of a nonqualified deferred annuity contract from an owner to a spouse or incident to a divorce is not considered a taxable distribution.

The cost basis of the person to whom the annuity is transferred is equal to the transferor's cost basis increased by the amount of gain he or she is required to recognize because of the transfer. In short, the transferee’s cost basis—unless the transferee is the transferor’s spouse or the transfer is incident to a divorce—usually will be equal to the annuity’s cash value on the date of transfer.

3.2.5 Exchange of the Annuity

If a nonqualified deferred annuity contract owner exchanges the annuity under IRC §1035, he or she may replace the annuity with another annuity or qualified long term care insurance contract entirely tax-free. In order for the §1035 exchange to be tax-free, however, the contract owner must meet all of the requirements set out in the Internal Revenue Code.

3.2.6 Annuity Surrender

A consumer may surrender a nonqualified deferred annuity contract for its cash value. The amount of the proceeds paid upon surrender is taxable as ordinary income to the extent such proceeds exceed the contract owner's cost basis in the contract.

3.2.7 Amounts Not Received as an Annuity Subject to Tax Penalties

Any amount received by a consumer under a nonqualified deferred annuity that is not received as an annuity is subject to a premature distribution tax penalty unless an exception applies. Such amounts include cash value withdrawals, annuity loans, sales, gifts (other than to a spouse or incident to a divorce) and surrenders. The amount of the premature distribution tax penalty is equal to 10% of the amount includable in the contract owner's income.

As discussed earlier, the exceptions to the premature distribution tax penalty apply to distributions:

- Made on or after the individual becomes age 59½;
- Attributable to the individual’s becoming disabled;
- Allocable to investment in the contract before August 14, 1982;
- Made on or after the contract owner’s death;
- Made under an immediate annuity contract;
- Made from an employer-purchased annuity upon the termination of a qualified plan; and
- That are part of a series of substantially equal periodic payments made for the life or life expectancy of the individual or the joint lives or joint life expectancies of the individual and his or her designated beneficiary.

3.2.8 Annuitizing the Annuity

A consumer annuitizes a nonqualified deferred annuity contract at the time he or she places the annuity’s cash value under a settlement option and receives periodic payments. Periodic payments received pursuant to a settlement option are considered amounts received as an annuity and enable the consumer to recover his or her cost basis in the contract tax-free over the payment period.

Although the tax treatment of periodic payments under a nonqualified annuity is consistent regardless of the type of annuitization, its calculation varies somewhat, depending upon whether the settlement option provides for fixed annuitization or variable annuitization.

3.2.8.1 Fixed Annuitization

An annuity that is annuitized under a fixed annuitization settlement option provides unchanging periodic payments for the duration of the annuitization period. Determining the portion of each fixed periodic payment that is tax-free as a recovery of the annuity's cost basis requires the calculation of an exclusion ratio, which is calculated by dividing the investment in the contract by the total expected return. Each periodic payment is then multiplied by the exclusion ratio, and the result is the amount of the periodic payment that is tax-free until all cost basis has been recovered.

Calculating the exclusion ratio simply requires that the appropriate values be substituted into the following equation:

Investment in the contract ÷ Total expected return = Exclusion ratio

For purposes of substituting into the above equation, the “investment in the contract” is an amount equal to the contract owner's cost basis. The cost basis, in the case of a nonqualified annuity, is equal to the total premiums paid less any distributions (withdrawals, loans or dividends). Thus, if a nonqualified deferred annuity contract owner made a single $100,000 premium payment and never received a distribution under the contract, his or her investment in the contract would be $100,000.

The “total expected return” is simply the total amount the annuitant expects to receive over the entire annuitization period. For example, if annual periodic payments of $13,333 each are to be made under the settlement option for a period of 10 years, the total expected return would be $133,330. ($13,333 x 10 = $133,330)

Substituting these two values into the exclusion ratio equation, we can see that the exclusion ratio is .7500. ($100,000 ÷ $133,330 = .7500) To determine the portion of each annual periodic payment that is tax-free as a recovery of basis, just multiply the periodic payment by the exclusion ratio. The tax-free amount in this case is $10,000. ($13,330 x .75 = $10,000)

Calculating the exclusion ratio when periodic payments are payable for a consumer's lifetime, rather than for a fixed period such as 10 years, is different only to the extent of the total expected return. To determine the total expected return in the case of a life annuity we need only consult a life expectancy table. The annuitant’s annual periodic payments are then multiplied by his or her life expectancy; the result is the total expected return for purposes of the exclusion ratio equation.

For example, suppose a consumer purchased a nonqualified deferred annuity and, over the years, paid net premiums of $200,000. At the time of annuitization at the consumer's age 60, the deferred annuity cash value had grown to $300,000. The monthly fixed periodic payments the consumer would receive for life under a straight life annuity are $1,488, i.e. $17,856 annually. By consulting the table below, we determine that the consumer's life expectancy at the time of annuitization is 24.2 years. (See highlighted portion of the table.)

Table V—Ordinary Life Annuities—One Life—Expected Return Multiples (excerpt)					
Age	***Multiple***	***Age***	***Multiple***	***Age***	***Multiple***
55	28.6	64	20.8	73	13.9
56	27.7	65	20.0	74	13.2
57	26.8	66	19.2	75	12.5
58	25.9	67	18.4	76	11.9
59	25.0	68	17.6	77	11.2
60	24.2	69	16.8	78	10.6
61	23.3	70	16.0	79	10.0
62	22.5	71	15.3	80	9.5
63	21.6	72	14.6	81	8.9

By multiplying the annual annuity payments of $17,856 by 24.2 years we can see that the consumers total expected return under this life annuity is $432,115. ($17,856 x 24.2 = $432,115) In order to determine the portion of each periodic payment that is tax-free as a recovery of the consumer’s cost basis, we need only to substitute the appropriate values into the exclusion ratio equation.

Since we know that the consumer’s cost basis in the deferred annuity is $200,000 and the total expected return is $432,115, we can easily determine that the exclusion ratio is .4628.

$200,000 ÷ $432,115 = .4628

We then simply need to multiply each $1,488 monthly periodic payment by .4628 to determine that $688.65 of each periodic payment is tax-free as a recovery of the consumer's cost basis. The $799.35 balance of each periodic payment is taxable as ordinary income. Thus, in a year in which the consumer received 12 monthly periodic payments, the total tax-free amount would be $8,263.80. ($688.65 x 12 = $8,263.80)

3.2.8.2 Variable Annuitization

Determining the portion of each periodic payment under a settlement option providing for variable periodic payments is somewhat simpler. All that needs to be done in the case of life annuity payments made under variable annuitization is to divide the consumer's cost basis by the number of years in his or her life expectancy. The result of that calculation is the amount of the annual periodic payment that is tax-free until the consumer's entire cost basis has been fully recovered. Once the consumer's cost basis is fully recovered, all further periodic payments are completely taxable.

For example, suppose the facts are the same as those in the last example. In that case, the consumer's cost basis was $200,000, and her life expectancy at age 60 was 24.2 years. By dividing the consumer's $200,000 cost basis by her 24.2 year life expectancy, we can see that she will recover $8264.46 of her cost basis tax-free each year. ($200,000 ÷ 24.2 = $8,264.46) Although there are minor differences between the two methods of determining the tax-free amount, the results are approximately the same.

3.3 Mortality & Expense (M&E) Risk Charges and Investment Advisory Fees

A clear and concise disclosure of annuity expenses, fees and other charges also needs to be made to a consumer. Certain annuity contracts, particularly variable annuities, are inherently more costly for an insurer to offer. The increased costs that are characteristic of variable annuities, not unlike other contract-specific costs, are passed along to the consumers who purchase them.

Principal among the additional expenses associated with variable annuities that are not imposed on other annuities are:

- Mortality and expense (M&E) risk charges; and
- Investment advisory fees.

Mortality and expense risk charges are imposed by insurers who issue variable annuities to compensate them for the additional mortality risks and expense risks they assume as a result of issuing those contracts.

The mortality risks an insurer assumes that are compensated for through its imposition of M&E risk charges are:

- The risk that the death benefit payable upon the contract owner's death during the accumulation period will exceed the annuity cash value on the date of death; and
- The risk that the consumer will outlive his or her life expectancy during the contract's annuitization period, resulting in the insurer's need to make additional, unanticipated periodic payments.

M&E risk charges are deducted from the separate account. The extent of such charges varies considerably from one insurer to the next and may be as low as .5% in some variable annuities to 2% in others.

Investment advisory fees are fees imposed at the fund, rather than the separate account, level and compensate the adviser for the investment advisory services it provides. Such fees are normally imposed at a higher level for more complex funds. Thus, the investment advisory fees associated with the management of a global stock variable subaccount might vary from .7% to 2% annually while the investment advisory fees associated with the management of a money market fund variable subaccount are more likely to vary from .3% to .6% annually.

Although the M&E risk charges and investment advisory fees generally appear fairly modest, they can have a significantly negative effect on a consumer's ability to accumulate cash value in the annuity contract. Suppose a variable annuity contract owner makes annual $10,000 premium payments to the annuity and receives annual interest at a net 8% interest rate. Based on those assumptions, the consumer will have accumulated $494,229 at the end of 20 years and almost $2.8 million at the end of 40 years.

However, if the contract owner's annuity imposed higher annual fees that resulted in a net 7% interest rate credited to the cash value, the consumer would have accumulated $438,652 at the end of 20 years and slightly more than $2.1 million at the end of 40 years. Consider the difference in accumulations under the two different fee structures, as shown in the following chart:

Year	Accumulation at 8% Net Interest	Accumulation at 7% Net Interest	Dollar Difference	Percentage Difference
5	$ 63,359	$ 61,533	$ 1,826	-2.9%
10	156,455	147,836	8,619	-5.5%
15	293,243	268,881	24,362	-8.3%
20	494,229	438,652	55,577	-11.2%
25	789,544	676,765	112,779	-14.3%
30	1,223,459	1,010,730	212,729	-17.4%
35	1,861,021	1,479,135	381,886	-20.5%
40	2,797,810	2,136,096	661,714	-23.7%

It seems clear that even a relatively small difference in annual fees imposed by an insurer can have a disproportionately large negative effect on the consumer's ability to accumulate the cash value needed to meet his or her financial objectives and must be thoroughly discussed.

3.4 Rider Charges and Features

Insurers offer a wide range of additional benefits that may be added by rider on their annuity contracts. An insurance producer, when recommending such additional benefits, must ensure that the consumer has been reasonably informed with respect to their potential charges and features.

Among the popular riders available that may be added to deferred annuity contracts—whose features and charges must be discussed if recommended—are the following:

- Guaranteed living benefits, such as –
  - Guaranteed minimum accumulation benefits (GMAB),
  - Guaranteed minimum income benefits (GMIB),
  - Guaranteed minimum withdrawal benefits (GMWB), and
  - Guaranteed lifetime withdrawals benefits (GLWB);
- Enhanced death benefits, including –
  - Death benefit rollup riders, and
  - Death benefit step-up riders;
- Long term care insurance riders; and
- Inflation riders.

Although riders may be added to deferred annuity contracts and provide meaningful benefits for a consumer, such additional benefit riders may involve substantial ongoing charges that negatively impact the consumer's ability to accumulate the funds necessary to meet objectives. When explaining the features and charges of recommended riders, the insurance producer should discuss both the current charges as well as the negative effect those charges may have on cash values.

3.5 Limitations on Interest Crediting

The crediting of interest on cash values in a deferred annuity may be based on an interest rate:

- Periodically declared by the insurer, i.e. a declared-rate annuity;
- Determined by the investment performance of a separate account, i.e. a variable annuity; or
- Calculated on the basis of the change in the closing level of a specified external index and modified by applicable crediting factors, i.e. an indexed annuity.

Although the applicable interest rates under declared-rate annuities and variable annuities are not generally limited by other than the insurer's crediting declaration or a separate account’s investment results, interest crediting may be limited by certain factors in an indexed annuity. Such factors and their effect on index interest rate crediting need to be fully discussed.

When an unadjusted index interest rate is calculated in an indexed annuity based on the change in the closing levels of the applicable index, certain factors, known collectively as "crediting factors" may be applied that increase or decrease the unadjusted interest rate. The crediting factors that may apply in an indexed annuity are:

- A participation rate;
- A margin or spread; and
- A cap rate.

An indexed annuity's participation rate is the percentage of the unadjusted index interest rate credited to the cash values allocated to an index strategy, subject to the applicability of other crediting factors. The annuity's participation rate may be guaranteed or non-guaranteed and may vary from 50% to 150%.

The margin or spread in an indexed annuity is a percentage by which the index interest rate is reduced before being credited to the cash value allocated to an index strategy. Similar to other crediting factors, a margin or spread may be guaranteed or non-guaranteed. Although an indexed annuity does not necessarily have a margin or spread, when they are included in an indexed annuity they usually amount to 1% to 5%.

An indexed annuity's cap rate is an upper limit on the amount of interest that may be credited on cash value allocated to the index strategy. Not all indexed annuities impose cap rates, and such rates, when imposed, may be guaranteed or non-guaranteed.

If an insurance producer recommends an indexed annuity to a consumer, the consumer must be reasonably informed of any limitations on interest crediting that may apply in the recommended annuity. Furthermore, the insurance producer should illustrate the effect on interest rates of each of the crediting factors included in the contract.

3.6 Insurance and Investment Components

Variable annuities possess characteristics as an insurance product and as an investment, and both of those important components must be disclosed to a consumer in a variable suitable annuity recommendation. With respect to the insurance component of the recommended variable annuity, an insurance producer must have a reasonable basis to believe that the consumer has been informed concerning:

- Death benefit guarantees, if any;
- Nonforfeiture provisions;
- Withdrawal and loan provisions;
- Fixed account principal and interest guarantees;
- Surrender charges;
- Administration and maintenance fees; and
- Annuitization provisions.

In addition to ensuring a consumer has been informed as to the variable annuity's insurance component, an insurance producer recommending a variable annuity must also explain the basic characteristics of its investment elements, including:

- The nature of accumulation units and how they are purchased;
- The use of the separate account to which the consumer may allocate some or all premiums and cash value;
- The consumer's ability to transfer cash value from one variable subaccount to another without the need to recognize income;
- The ability to revise future premium allocations as frequently as desired;
- The availability of the annuity's cash value management tools, that may include –
    - Dollar cost averaging,
    - Automatic subaccount balancing, and
    - Interest sweep;
- The factors that affect the separate account's investment returns, including –
    - Dividend and interest income,
    - Realized capital gains and losses, and
    - Unrealized appreciation or depreciation; and

- The investment options available in the separate account's variable subaccounts and their–
    - Fees,
    - Objectives,
    - Investment policies, and
    - Risks.

3.7 Market Risk

The insurance industry and its products have traditionally been characterized by their guarantees. Such guarantees, with respect to annuity products, have included:

- A guaranteed lifetime fixed income;
- Guaranteed principal; and
- Minimum interest guarantees,

Because of the long association of insurance products with solid guarantees, consumers may be unfamiliar with the risks to which their purchase of a variable annuity and their allocation of premiums and cash values to the variable subaccounts that comprise the insurer's separate account may expose them. In order for an insurance producer to meet the disclosure requirements in connection with the recommendation and sale of a variable annuity, the insurance producer must fully explain the market risk to which they may be exposed.

"Market risk" is defined as the risk of decline in investment returns due to market factors independent of the given security or property investment. Those market factors include political, economic and social events as well as changes in investor preferences. So, an insurance producer's suitable disclosure of a variable annuity's market risk would normally include a general explanation of the various political and other events that could reasonably impact investment returns in the separate account.

Section Review

3.8 Section Review

1. What taxation regimen applies to distributions from a nonqualified deferred annuity?

    A. First in first out (FIFO)

    B. Last in first out (LIFO)

    C. Qualified dividend treatment

    D. Capital gain treatment

2. Harvey paid $100,000 for his nonqualified deferred annuity. He pledged the annuity as collateral for a $25,000 loan from his local bank. If the annuity cash value was $105,000 at the time of the bank loan and Harvey had never previously taken a distribution, what income, if any, must he recognize as a result of the loan?

    A. $5,000

    B. $20,000

    C. $25,000

    D. $0

3. Arthur transferred the ownership of his nonqualified deferred annuity contract to his daughter as a gift. If he paid net premiums of $50,000 for the annuity and its cash value on the date of the transfer was $60,000, how much income, if any, must Arthur recognize as a result of the transfer?

    A. $60,000

    B. $50,000

    C. $10,000

D. $0

4. Shelly's cost basis in her nonqualified deferred variable annuity was $100,000 at the time she annuitized it under a straight life annuity that will give her annual variable period payments of $15,000. If her life expectancy at the time of annuitization was 20 years, how much of each periodic payment is tax-free as a recovery of her cost basis?

   A. $0

   B. $15,000

   C. $10,000

   D. $5,000

5. Harry's indexed annuity has an 80% participation rate and a 2% margin. What interest rate is applied to funds allocated to the index strategy if the unadjusted interest rate was 30%?

   A. 30%

   B. 22%

   C. 28%

   D. 24%

Answers to Section Review Questions

Section 1

1. C. Principal among the reasons why a consumer's age would impact the suitability of an annuity for him or her are a) the existence of surrender charges imposed on contract surrenders and withdrawals exceeding an annual surrender charge-free withdrawal limit, and b) the tax treatment to which distributions other than as an annuity are subject.

2. B. Henry must recognize income of $5,000 as a result of the loan. A distribution from a deferred annuity's cash value as a result of a withdrawal or loan is deemed to come first from the annuity's gain that is subject to income taxation as ordinary income. Only after all gain has been distributed will any further distribution from the annuity be considered tax-free as a recovery of the contract owner's cost basis. This is known as "last in, first out" (LIFO) tax treatment.

3. C. Annuity periodic payments may begin at any age. However, annuities, because of their relatively high expense levels, their surrender charges that may extend for ten or more years and their tax treatment, are inappropriate to enable consumers to meet short-term objectives.

4. A. Publicly-traded stocks. A consumer's liquid net worth consists of the aggregate value of a) savings accounts; b) cash and cash equivalents; c) publicly-traded stocks and bonds; and d) mutual funds. The consumer assets *not* considered liquid include a) real estate holdings, including residences, vacation homes and raw land; b) closed corporation stock; c) equity in the consumer's business; d) vehicles; and e) other tangible personal property.

5. D. Shirley's risk tolerance level is conservative. While other models of consumer risk tolerance identify additional levels of risk tolerance—conservative to moderate and moderate to aggressive, for example—a consumer's risk tolerance may generally be considered a) conservative if the most important concern is capital preservation and the consumer has an extremely low tolerance for possible investment loss; b) moderate if the consumer is will to accept the possibility of some principal loss in order to achieve potentially higher returns; or c) aggressive if the consumer is willing to accept the possibility of substantial loss—possibly as high as a 40% loss within a one year period—in order to achieve potentially very high returns.

Section 2

1. B. The benefit paid under the GMAB would be $20,000. Under a guaranteed minimum accumulation benefit (GMAB), the insurer guarantees that if the deferred annuity's cash value is less than the GMAB benefit base—an amount typically equal to the consumer's first year premiums—at the end of the prescribed holding period, the insurer will increase the cash value to equal the benefit base. In this case, the GMAB would add $20,000 to the annuity's cash value.

2. D. No further suitability requirements apply. The insurance producer has no suitability requirement as to asset allocation to the variable subaccounts other than at the time of initial premium allocation.

3. A. Phyllis will not be required to recognize any income. Under a §1035 tax-free exchange, the deferred annuity contract owner's cost basis in the exchanged annuity becomes the owner's cost basis in the annuity contract issued pursuant to the exchange. Furthermore, the tax-deferred gain under the original annuity is carried over to the new annuity.

4. D. Neither an enhanced death benefit nor a guaranteed living benefit is carried over from a replaced annuity to the replacement annuity. Replacement or exchange of a deferred annuity results in the loss of enhanced death benefits and guaranteed living benefits provided under the replaced annuity.

5. C. If the insurance producer sells an annuity to a consumer who refuses to provide suitability information, the producer must obtain a statement, signed by the consumer, documenting his or her refusal to provide suitability information.

Section 3

1. B. Cash value withdrawals and other distributions from a nonqualified annuity receive last in first out (LIFO) tax treatment under which all taxable gain—the annuity's cash value in excess of the

contract owner's net premiums, in other words—is deemed to be distributed before any tax-free cost basis is deemed distributed.

2. A. Harvey must recognize $5,000 as income. A nonqualified deferred annuity contract owner may pledge or assign an annuity contract for a loan. Regardless of whether the annuity loan is made by the insurer or made by a lending institution and secured by the annuity's pledged cash value, the amount received is considered a distribution from the annuity and the lesser of the gain or the loan is taxed as an amount not received as an annuity.

3. C. Arthur must recognize income of $10,000. An individual who transfers an annuity contract issued after April 22, 1987 for less than adequate consideration—unless the transfer is between spouses or incident to a divorce—is treated as having received as a taxable distribution the amount by which the cash value on the date of the gift exceeds the cost basis. In other words, if the contract owner makes a gift of the annuity, he or she must recognize the gain on the annuity as ordinary income in the year in which the gift is made.

4. D. $5,000 of each periodic payment is tax-free as a recovery of principal. Determining the portion of each periodic payment under a settlement option providing for variable periodic payments requires that the consumer's cost basis be divided by the number of years in his or her life expectancy. The result of that calculation is the amount of each periodic payment that is tax-free until the consumer's entire cost basis has been fully recovered. Once the consumer's cost basis is fully recovered, all further periodic payments are completely taxable.

5. B. Interest would be credited at 22%. An indexed annuity's participation rate is the percentage of the unadjusted index interest rate credited to the cash values allocated to an index strategy, subject to the applicability of other crediting factors. The margin or spread in an indexed annuity is a percentage by which the unadjusted index interest rate is reduced before being credited to the cash value allocated to an index strategy.

Glossary

Annuity	"Annuity" means an annuity that is an insurance product under state law that is individually solicited, whether the product is classified as an individual or group annuity.
Continuing education provider	"Continuing education provider" or "CE provider" means an individual or entity that is approved to offer continuing education courses.
Insurer	"Insurer" means a company required to be licensed under the laws of the state to provide insurance products, including annuities.
Insurance producer	"Insurance producer" means a person required to be licensed under the laws of this state to sell, solicit or negotiate insurance, including annuities.
Market risk	“Market risk” is defined as the risk of decline in investment returns due to market factors independent of the given security or property investment.
Recommendation	"Recommendation" means advice provided by an insurance producer, or an insurer where no producer is involved, to an individual consumer that results in a purchase, exchange or replacement of an annuity in accordance with that advice.
Replacement	''Replacement'' means a transaction in which a new policy or contract is to be purchased, and it is known or should be known to the proposing producer, or to the proposing insurer if there is no producer, that by reason of the transaction, an existing policy or contract has been or is to be: • Lapsed, forfeited, surrendered or partially surrendered, assigned to the replacing insurer or otherwise terminated; • Converted to reduced paid-up insurance, continued as extended term insurance, or otherwise reduced in value by the use of nonforfeiture benefits or other policy values; • Amended so as to effect either a reduction in benefits or in the term for which coverage would otherwise remain in force or for which benefits would be paid; • Reissued with any reduction in cash value; or • Used in a financed purchase.
Suitability information	"Suitability information" means information that is reasonably appropriate to determine the suitability of a recommendation, including the following: • Age; • Annual income; • Financial situation and needs, including the financial resources used for the funding of the annuity; • Financial experience; • Financial objectives; • Intended use of the annuity; • Financial time horizon; • Existing assets, including investment and life insurance holdings; • Liquidity needs; • Liquid net worth; • Risk tolerance; and • Tax status.