National Association for Indexed Products 2001

Index annuities are underwritten by insurance companies. They are a fixed annuity and share the same features as other fixed annuities:

* Tax deferral of interest compounding inside the annuity
* Lifetime income options
* Minimum interest guarantees
* Surrender charges
* Interest earnings are often available through free withdrawals
* Regulated as an insurance product, not a security

Tax Deferral

The interest earned inside an index annuity grows on a tax-deferred basis. However, tax-deferred doesn't mean tax-free. Interest withdrawn from the annuity is subject to income taxes in the year it is received and upon death of the annuity owner all interest earnings are taxable. In addition, interest withdrawn from an annuity before the owner is age 59 1/2 is subject to an additional IRS "premature distribution" penalty, unless the distribution meets certain exceptions - taxes or penalties do not apply on the original principal. Consult your tax advisor for your personal situation.

You have probably seen charts showing the power of tax-deferral. Usually the chart shows a sum accumulating on a tax-deferred basis and another sum growing on a taxable one. The two lines begin together, but by the time twenty or thirty years has passed the tax-deferred growth line has surged into the stratosphere while the taxable line is struggling to maintain altitude, thus illustrating that tax-deferred growth really adds up.

The only problem with the example is in its relevance to the intended audience. If the average fixed annuity buyer is in their sixties they may not appreciate how wonderful tax-deferral is if one talks about the big payoff occurring when age 85, 90 or 95 is reached.

The power of tax-deferral may be communicated by simplifying the benefit story. To do this grab five $20 bills, and a stack of dollar coins. Consider that…

One of the great benefits of an annuity is that it gives the buyer tax control. Tax control means that the annuity owner decides when to spend the interest and pay the taxes - not the IRS. Tax control lets the consumer earn money on tax dollar instead of the government.

Let's say the annuity owner didn't need $100 of the interest income produced this year by the annuity to live on. Instead that $100 was left inside the annuity for future use. One might be able to leave more interest in the annuity for future use, but let's simply use $100.

If the annuity owner was in the 20% combined federal and state tax bracket deferring that $100 in interest would save the person $20 today in taxes. (Place a $20 bill on the table). Although many annuity owners are in higher tax brackets meaning that the annuity would save even more in taxes, let's simply use 20% in this example.

Although at some point in time somebody will need to take the interest and pay the taxes, in the meanwhile interest is earned on the taxes that one doesn't pay today. If you could earn 5% on those tax dollars you'd have an extra dollar at the end of one year (Roll out a gold dollar). One could probably earn more than 5%, but let's simply make it 5%. Even if the annuity owner decided to pay that $20 of deferred taxes back at the end of the year - because tax-deferral doesn't mean tax-free, the annuity owner would still keep most of that dollar. So, tax control made the annuity owner a buck; enough to buy a cup of coffee.

If you left that $100 of interest in the annuity for two years you'd have $2 (Roll out another gold dollar) - enough for a hamburger. At the end of three years you'd have $3 (Roll out a gold dollar) - enough for a combo meal and after five years you'd have $5 (Roll out two more gold dollars) - which could get you a movie ticket. That's $5 in your hand even after the $20 in deferred taxes is paid back.

Tax-deferral has put cash in the annuity owner's pocket even though
Only $100 of interest was set aside to compound for the future,
A very low tax rate was assumed
Only 5% interest was earned, and
Only one year's interest was deferred.

If you deferred $100 in each of the next five years (Put down four more $20 bills) and earned 5% you'd have $15 in your pocket (Roll out ten more gold coins) thanks to tax control.

What happens if more than $100 a year of interest is retained for future growth? What if taxable dollars were shifted from a taxable interest account to the tax-deferred annuity. What if thousands of dollars were moved into the tax-deferred annuity? How much more money would the annuity put in your pocket ?"

Tax-deferral gives you tax control because the annuity owner decides when to take the interest and pay the taxes - not the IRS, and while tax-deferred isn't tax-free you get to keep most of the interest earned from taxes postponed. Tax-deferral is a simple yet powerful financial tool.

Lifetime Income Options

Annuities may be annuitized. This means that the accumulated value of the annuity contract may be used to provide a guaranteed income for a specific numbers of years, for as long as the payee or payees live, or for the greater of a specific number of years or until the payee dies.

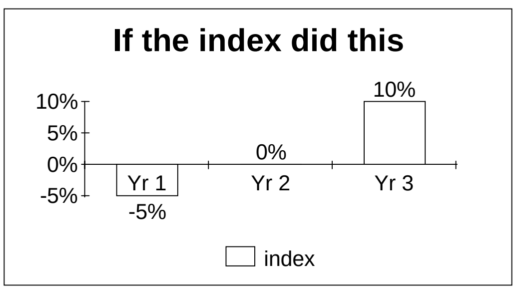
Minimum Interest Guarantees

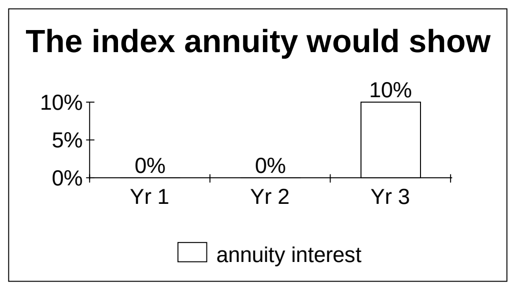
Every index annuity guarantees that at the end of the surrender period at least the original premium will be available, even if the index steadily declines. The minimum interest guarantee usually only applies if the total return for the surrender period is less than the guaranteed return. As an example, say that the annuity guaranteed 3% a year based on 100% of the premium. This means that at the end of a seven year term that annuity would return a minimum of $1.23 for each $1 of premium. If the external index increased so that the index annuity interest crediting method resulted in a 30 cent interest gain for the entire period the annuity contract would credit 30 cents- not 30 cents plus 23 cents.

3% Interest Compounding On $1

End of	*Yr 1*	*Yr 2*	*Yr 3*	*Yr 4*	*Yr 5*	*Yr 6*	*Yr 7*
	$1.0300	$1.0609	$1.0927	$1.1255	$1.1593	$1.1941	$1.2299

If the calculated index gain was zero for a year, the typical index annuity would not credit the minimum guarantee of 3% for that specific year, the contract would record 0% interest. The minimum guarantee is normally calculated over the entire surrender period and only applies if the total interest for the period averaged less than 3% a year. So, if the index annuity crediting formula produced returns of zero in year one, zero in year two and ten percent in year three the annuity contract wouldn't show 3%, 3%, 10%; instead it would show 0%, 0%, 10% because the overall gain is still higher than the minimum guarantee.





Most index annuities credit a minimum interest rate of 3% a year, however this is usually credited on less than the full premium so the actual minimum interest earned is less than 3% on the whole premium. If the minimum rate is calculated on less than the full premium this allows the insurance company to channel more of premium dollar to providing the potential for more excess interest. We'll explore this in depth in another section.

Surrender Charges

All index annuities charge a surrender penalty if the policy is cashed in prior to the end of the surrender period. Depending on the policy selected, the surrender period varies in length from one to eighteen years; the penalty does not usually apply if the policy is cashed in due to death of the owner.

Interest Earnings Are Often Available Through Free Withdrawals

Index annuities are designed as long term savings vehicles. If a consumer anticipates needing the interest earned on a regular basis they would be probably be better off with some other savings vehicle. Although index annuities are designed to provide for future goals, many index annuities enable owners to withdraw a portion of the accumulated value without incurring a surrender charge. However, all interest withdrawn is taxable and subject to the "premature distribution" IRS penalties.

An Insurance Product; Not A Security

The same licensing required for an agent to offer traditional fixed annuities is required for indexed annuities. Index annuities are regulated as insurance products and not as securities. The reason is that insurance products are not subject to SEC registration or regulations if they meet three “safe harbor” guidelines under SEC (Securities & Exchange) Rule 151. In general these guidelines require:

That the product be issued by a corporation subject to the supervision of a state insurance commissioner. All index products are issued by companies subject to state insurance regulation and registration.

The second guideline is that the insurance company assumes the investment risk - not the customer. Unlike variable annuities and variable life contracts an index annuity guarantees a minimum annual return and guarantees that once interest is credited it cannot be lost, even if the index declines.

In addition to the minimum interest rate an index product may credit additional interest beyond the minimum guarantee. All fixed annuities may credit excess interest above the minimum guarantee. Whether this excess interest is derived from the net investment income of the insurer’s portfolio or from the net income attributed to an index is immaterial. The insurance company still assumes the investment risk.

The third requirement is that the annuity is not marketed primarily as an investment. Index annuity owners do not have any direct or indirect ownership of any security or index.

The Only Difference

between a fixed index annuity and a traditional fixed annuity is in the crediting of excess interest earned above the minimum guarantee. Most index annuities base the crediting of excess interest on movements of the S&P 500. The S&P 500 Index includes a representative sample of 500 common stocks from companies trading on the New York Stock Exchange, American Stock Exchange and NASDAQ National Market System. The objective of the index is to be a benchmark for U.S. stock market performance. Index annuities also base crediting on movements of the Dow Jones Industrial Average, NASDAQ 100, Russell 2000, S&P MidCap 400 and bond and international indices. No index-linked product is sponsored, endorsed, sold or promoted by the index itself. Unlike an index mutual fund neither dividends nor capital gains are included in the index annuity interest calculation..

Index annuities are fixed annuities. With an index annuity you still have an owner, annuitant and beneficiary. The earnings grow without current taxation until withdrawn, and the “under age 59 1/2” IRS penalty applies. However, there are some new terms to learn.

Crediting Methodology refers to the way that total index movement is calculated before applying the participation rate. *Participation Rate* is the percentage of index gain that is credited to the annuity and may either be expressed as a percentage of calculated index movement, calculated by deducting an asset fee or yield spread, or may combine both methods.

We will cover the terms and an understanding of how index annuities do the things they do in the next section.

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This concludes Section 2 - Annuity Basics. Section 3 - Index Annuity Parts, will be available 3/1/01.