Equity Index Annuity Explained

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An annuity is a contract between an individual and an insurance company under which, in return for receiving a sum of money from the individual, the insurer agrees to pay a steady income based on the life of the annuitant. The annuitant may or may not be the owner—the person who enters into the contract and makes payments into the annuity.

Annuities can be broadly classed as fixed, which means earnings are guaranteed by the insurer, or variable, where there are no such guarantees because the annuity is invested in securities, subjecting the return to market fluctuations. Although riskier than a fixed annuity, variable annuities have the potential for greater returns that, theoretically at least, can keep pace with inflation.

An equity-indexed annuity (EIA) is a fixed annuity, but it has a feature that gives it, too, the potential for greater than guaranteed minimum returns. That feature is a link to a financial indicator or index, which may provide a greater return. Insurance companies structure EIAs in many different ways. Typical features are included here.

The most commonly used index is the S&P 500® Composite Stock Price Index (Standard and Poor's 500®, excluding dividends). If the S&P 500® goes up, so will the credited interest on the equity indexed annuity. If it goes down, the credited interest will do likewise. But the drop is limited by a minimum guaranteed interest rate. The actual credited interest will be the greater of the guaranteed rate or the credited interest generated by the index link.

Although the annuity's credited interest is linked to an index, an EIA is not considered a security because it is not actually invested in equity products. Like any other fixed annuity, the premiums are paid into the insurer's general account.

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The most popular annuities are those that are deferred; that is, the annuity will begin making income payments to the annuitant sometime in the future. A deferred annuity may be funded in one of two ways:

- A single-premium deferred annuity requires the owner to fund the annuity with a single substantial payment. The actual amount depends on the amount of income desired in the future. This type of annuity is often purchased by someone who has received or accumulated a large sum of money, such as an inheritance, the death benefit from a life insurance policy, a bank CD that has matured, or a retirement plan distribution.
- A flexible-premium deferred annuity allows the owner to make smaller periodic payments over the life of the annuity until such time as the annuitant will begin receiving income. Because the premium is flexible, the amount the owner pays may vary within limits established by the issuing insurer. Each premium payment may be increased or decreased if the owner's circumstances so warrant. Of course, if a specific amount of income is desired, attention must be given to the amount of premium required to purchase that future income.

The EIA contract is written for a specific term over which the growth of the index is computed. If the annuity is kept intact during that term, the owner is guaranteed at least a return of the principal, regardless of how the index performs. The term can range up to ten years. At the end of that period, the annuity owner has several choices:

- Renew the annuity for another term.
- Make a tax-free exchange for another annuity, either fixed or variable.
- Surrender the contract and receive its current value.
- Annuitize the contract (begin to receive periodic payments).

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During the term, the index value is noted on specific index dates for purposes of crediting interest to the EIA. The index dates are often anniversaries of the annuity's effective date.

On the index dates, the insurer uses an indexing method to measure the change in the index. There are three popular methods:

■ Annual reset or ratcheting compares the index value at the beginning of the year with its value at the end of the same year.
■ Point-to-point is similar to annual reset except earnings are based on the difference between the index value at the beginning and the end of a longer period of time, such as the index term or a period of five years, at the insurer's option.
■ High-water mark uses the difference between the index value at the start of the term and the highest value attained on an anniversary date during the term.

Interest on the EIA may or may not be credited to the account immediately. If interest is credited on the index dates, compounding of the interest occurs, providing a greater amount to accumulate in the annuity. Sometimes, however, interest is not credited until the end of the term.

Any interest paid accumulates in the annuity along with the premium payments. Taxes are deferred on the interest during the accumulation period as long as the funds are not withdrawn.

Equity-indexed annuities include a contractual participation rate or index rate, which refers to a percentage of the index gain that will actually be credited to the annuity. This percentage can vary from about 60% to 100%.

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■ Example: The participation rate stated in the contract is 80%. The index gain is 5%. The gain that will be credited to the EIA is 80% of 5%, or 4%.

Other factors that affect equity-indexed annuities include these:

■ Insurers typically set a cap rate on the percentage increase allowed. For example, if the cap rate is 10% and the index has a 20% increase, no more than 10% would be permitted.
■ Insurers may average the index values daily, monthly or annually, and use the average as the basis for the increased index value.
■ The "floor" is another name for the minimum interest rate that is guaranteed to be credited to the annuity.
■ Insurers often offer a guaranteed death benefit in the event the annuitant dies before the annuity payments begin. Death benefits may have to be taken in the form of annuity payments under some EIA contracts.

Because the most common purpose of an annuity is to accumulate retirement funds, an annuity should be considered a long-term proposition. To encourage owners to leave the annuity intact for a long period, insurers often assess a surrender charge if withdrawals are made early in the life of the annuity.

If the owner makes a withdrawal before reaching age 591/2, the IRS levies a 10% penalty tax, in addition to the regular income tax on the taxable portion of the withdrawal, unless certain exceptions apply. This applies to both partial and complete withdrawals.

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No tax penalty is assessed under these limited circumstances:

■ The owner dies;
■ The owner becomes disabled; or
■ The withdrawal is paid out as part of a series of substantially equal periodic payments made for the life or life expectancy of the owner, or for the joint lives or life expectancies of the owner and a beneficiary.

When the time comes to begin receiving income from the annuity, a number of options are available for how the income will be paid. These settlement options further define the annuity. They are:

■ Straight-life or life-only annuity. Payments cease when the annuitant dies, even if the entire investment in the annuity has not been paid out. This option is rarely selected since most people want to recoup the entire amount by leaving it to a beneficiary if the annuitant dies early.
■ Joint-life annuity. Typically there are two annuitants (although there may be more) and payments stop when either one dies. This option is used in cases where additional income is required for two people, but the single survivor does not require the additional income.
■ Joint-and-last-survivor annuity. Annuity payments are made until the death of the last annuitant. Sometimes, a reduced payment (often one-third or one-half) is made after the first annuitant dies, reflecting a smaller income need to support the second person.
■ Period-certain annuity. Income will be paid for a specified period of time until funds are exhausted. The amount of each payment is determined by the length of the period and the amount available in the annuity at the beginning of the payout.
■ Amount-certain annuity. A specified amount will be paid regularly. The length of time that amount will be paid depends on the amount available in the annuity at the start and the amount of each payment.

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■ Refund annuity. Offered in different forms, these forms are alike in that if the annuitant dies before fully receiving the income, the insurer will provide either a continuation of the income or a lump-sum settlement to a named beneficiary.

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What is an Equity-Indexed Annuity?
An equity-indexed annuity (EIA) is a fixed annuity with a minimum guaranteed interest rate, but that rate is paid only when it is greater than a rate linked to a known index in the equities markets—usually the S&P 500®. Historically, securities provide a greater return over time, and linking the annuity interest rate to an index gives it the potential for higher returns. Although linked to the index, an EIA is not actually invested in securities.

How Does an EIA Work?
Funds are deposited into the insurer's general accounts for a specific term, at the end of which the owner is guaranteed that at least all of the principal will be returned. During this period, on specified index dates, the interest is calculated using one of several methods that compare the index value from one point in time to another. Interest may be credited on the index dates or at the end of the term.

Insurers set a maximum participation rate, which is a percentage of the index gain that will actually be paid as earnings. With a participation rate of 80%, if the index gains 20%, the EIA interest rate will be 80% of 20%, or 16%.

At the end of the index term, the EIA owner has four choices:
■ Renew the annuity for another term.
■ Make a tax-free exchange for another annuity, fixed or variable.
■ Surrender the contract and receive its current value in a lump sum.
■ Annuitize the contract (begin to receive periodic payments from it).

Numerous options are available for how the periodic payments may be made.

What Are the Benefits of an EIA?
■ Safe investment with guaranteed minimum interest rate, plus the potential to receive a higher rate
■ Guaranteed return of all of the principal if the contract is kept in force for the full index term
■ Any interest credited to the account during the term adds to growth
■ Tax-deferral of interest earned
■ Withdrawal privileges
■ Variety of options for receiving income from the annuity

How Are Distributions Taxed?
Distributions of gain are taxed at the owner's ordinary income tax rates and may be subject to a 10% federal tax penalty if taken prior to age 591/2.