Key Topics:

- Seniors
- Tax-deferred
- Death Benefit
- Deferred Annuity
- Immediate Annuity
- Sales Charge
- IRAs

WHAT'S INSIDE

Variable Annuities: Beyond the Hard Sell

The marketing efforts used by some variable annuity sellers deserve scrutiny—especially when seniors are the targeted investors. Sales pitches for these products might attempt to scare or confuse investors. One scare tactic used with seniors is to claim that a variable annuity will protect them from lawsuits or seizures of their assets. Many such claims are not based on facts, but nevertheless help land a sale. While variable annuities can be appropriate as an investment under the right circumstances, as an investor, you should be aware of their restrictive features, understand that substantial taxes and charges may apply if you withdraw your money early, and guard against fear-inducing sales tactics.

FINRA is issuing this Investor Alert to help seniors and other prospective variable annuity buyers to make informed decisions about how to invest for their retirement. This Alert focuses solely on *deferred variable* annuities and the unique issues they raise for investors.

What Are Variable Annuities?

Although **variable annuities** offer investment features similar in many respects to mutual funds, a typical variable annuity offers three basic features not commonly found in mutual funds:

- Tax-deferred treatment of earnings;
- A death benefit; and
- Annuity payout options that can provide guaranteed income for life.

Generally, variable annuities have two phases:

- The "accumulation" phase when investor contributions—**premiums**—are allocated among investment portfolios—**subaccounts**—and earnings accumulate; and
- The "distribution" phase when you withdraw money, typically as a lump sum or through various annuity payment options.

If the payments are delayed to the future, you have a **deferred annuity**. If the payments start immediately, you have an **immediate annuity**.

As its name implies, a variable annuity's rate of return is not stable, but varies with the stock, bond, and money market subaccounts that you choose as investment options. There is no guarantee that you will earn any return on your investment and there is a risk that you will lose money. Because of this risk, variable annuities are securities registered with the Securities and Exchange Commission (SEC). The SEC and FINRA also regulate sales of variable insurance products.

Evaluating Variable Annuities

The variety of features offered by variable annuity products can be confusing. For this reason, it can be difficult for investors to understand what's being recommended for them to buy—especially when facing a hard-charging salesperson. Before you consider purchasing a variable annuity, make sure you fully understand all of its terms. Carefully read the prospectus. Here are seven factors you should bear in mind before investing:

1) Liquidity and Early Withdrawals

Deferred variable annuities are long-term investments. Getting out early can mean taking a loss. Many variable annuities assess surrender charges for withdrawals within a specified period, which can be as long as 6 to 8 years. Also, any withdrawals before an investor reaches the age of 59 ½ are generally subject to a 10 percent tax penalty in addition to any gain being taxed as ordinary income.

2) Sales and Surrender Charges

Most variable annuities have a sales charge. Like **Class B shares** of mutual funds, many variable annuities shares typically do not charge a front-end sales charge, but they do impose asset-based sales charges or surrender charges. These charges normally decline and eventually are eliminated the longer you hold your shares. For example, a surrender charge could start at 7 percent in the first year and decline by 1 percent per year until it reaches zero.

3) Fees and Expenses

In addition to sales and surrender charges, variable annuities may impose a variety of fees and expenses when you invest in them, such as:

- **Mortality and expense risk charges**, which the insurance company charges for the insurance to cover:
  - Guaranteed death benefits;
  - Annuity payout options that can provide guaranteed income for life; or
  - Guaranteed caps on administrative charges.
- **Administrative fees**, for record-keeping and other administrative expenses;
- **Underlying fund expenses**, relating to the investment subaccounts; and
- **Charges for special features**, such as:
  - Stepped-up death benefits;
  - Guaranteed minimum income benefits;
  - Long-term health insurance; or
  - Principal protection.

These annual fees on variable annuities can reach 2 percent or more of the annuity's value. Remember, you will pay for each variable annuity benefit. If you don't need or want these features, you should consider whether this is an appropriate investment for you.

4) Taxes

While earnings in a variable annuity accrue on a tax-deferred basis—typically a big selling point—they do not provide all the tax advantages of 401(k)s and other before-tax retirement plans. 401(k)s and other before-tax retirement plans not only allow you to defer taxes on income and investment gains, but allow your contributions to reduce your current taxable income. That's why most investors should consider annuity products only after they make their maximum contributions to their 401(k)s and other before-tax retirement plans. To learn more about 401(k)s, please read *Smart 401(k) Investing*, available online at *www.finra.org*.

Once you start withdrawing money from your variable annuity, earnings (but not principal) will be taxed at the ordinary income rate, rather than at the lower capital gains rates applied to investments in stocks, bonds, mutual funds or other non-tax-deferred vehicles in which funds are held for more than one year.

Furthermore, proceeds of most variable annuities do not receive a "step-up" in cost basis when the owner dies. Other types of investments, such as stocks, bonds, and mutual funds, do provide a step up in tax basis upon the owner's death.

5) Bonus Credits

In an attempt to attract investors, many variable annuities offer bonus credits that can add a specified percentage to the amount invested in the variable annuity, generally ranging from 1 to 5 percent for each premium payment you make. Bonus credits, however, are usually not free. In order to fund them, insurance companies typically impose high mortality and expense charges and lengthy surrender charge periods.

Exchanging or Replacing Your Current Annuity

Variable annuity sales often drop along with declines in the equity marketplace. An exchange of an existing annuity for a new annuity may be the only way a salesperson can generate additional business. However, the new variable annuity may have a lower contract value and a smaller death benefit. You should exchange your annuity only when it is better for you and not just better for the person trying to sell you a new annuity. To learn more about exchanges, please read our Investor Alert, *Should You Exchange Your Variable Annuity*?

6) Guarantees

Insurance companies issuing variable annuities provide a number of specific guarantees. For example, they may guarantee a death benefit or an annuity payout option that can provide income for life. These guarantees are only as good as the insurance company that gives them. While it is an uncommon occurrence that the insurance companies that back these guarantees are unable to meet their obligations, it happens. There are several credit rating agencies that rate a company's financial strength. Information about these firms can be found on the Securities and Exchange Commission's website, *www.sec.gov*.

7) Variable Annuities within IRAs

Investing in a variable annuity within a tax-deferred account, such as an individual retirement account (IRA) may not be a good idea. Since IRAs are already tax-advantaged, a variable annuity will provide no additional tax savings. It will, however, increase the expense of the IRA, while generating fees and commissions for the broker or salesperson.

Also, if the annuity is within a traditional (rather than a Roth) IRA, the government requires that you start withdrawing income no later than the April 1 that follows your 70½ birthday, regardless of any surrender charges the annuity might impose.

Individual Retirement Annuities

Alert. Some variable annuity providers sell what is termed an Individual Retirement Annuity (IRA). You should be aware that this "IRA" is not an Individual Retirement Account (IRA). The Internal Revenue Service sets specific restrictions regarding Individual Retirement Annuities, which are not met by all annuity products. To learn more, please read *IRS Publication 590*.

How to Protect Yourself

Brokers recommending variable annuities must explain to you important facts, including:

- **liquidity issues**, such as potential surrender charges and 10 percent tax penalties;
- **fees**, including mortality and expense charges, administrative charges, and investment advisory fees; and
- **market risk**.

Brokers also must collect important information from you about your age, marital status, occupation, financial and tax status, investment objectives, and risk tolerance to assess whether a variable annuity is suitable for you.

Before purchasing a variable annuity, you should specifically—**Ask the person recommending that you purchase a variable annuity**:

- How long will my money be tied up? Are there surrender charges or other penalties if I withdraw funds from the investment earlier than I anticipated?
- Will you be paid a commission or receive any type of compensation for selling the variable annuity?
- How much?
- What are the risks that my investment could decrease in value?
- What are all the fees and expenses?

Check Out Your Investment Professional

Good Idea. Check FINRA BrokerCheck at *www.finra.org/brokercheck* to learn whether your investment professional is licensed and has a history of complaints. **And remember to ask yourself**:

- Am I already contributing the maximum amount to my 401(k) plan and other tax-deferred retirement plans?
- Do I have a long-term investment objective? Am I going to need the money before the surrender period ends (usually at least seven to 10 years)? Will I need the money before I'm 59½?
- Do I understand how the variable annuity works, the benefits it provides, and charges I have to pay?
- Have I read and understood the prospectus?
- Are there special features provided such as added long-term care insurance that I don't need?
- If I've decided to purchase a variable annuity, have I shopped around and compared the features of various variable annuities, such as sales loads and other fees and expenses?
- Do I understand the effect annuity payments could have on my tax status?
- If I'm considering purchasing a variable annuity within an IRA, do I understand that IRAs already provide for tax-deferred savings?
- Am I being pressured into making a quick purchase?

Have You Already Purchased a Variable Annuity?

If you have purchased a variable annuity and now have second thoughts, the policy may have a "free look" period that allows you to cancel within a specific period.

If you believe a variable annuity sale has violated FINRA rules, you can file a complaint online at FINRA's Investor Complaint Center at *www.finra.org/complaint*.

More Information

For additional information, the following resources are available at *www.finra.org*:

- Understanding Professional Designations
- Investor Alert: *Should You Exchange Your Variable Annuity?*
- Investor Alert: *Should You Exchange Your Variable Life Insurance Policy?*
- Investor Alert: *Equity Indexed Annuities—A Complex Choice*
- SEC: *Variable Annuities: What You Should Know*

To receive the latest Investor Alerts and other important investor information sign up for Investor News at *www.finra.org/investor*.

Investor Resources

FINRA Investor Information—Investor Alerts, tools and much more to help you invest smarter and safer.

Website: *www.finra.org/investor*
Phone: (202) 728-6964

FINRA BrokerCheck—Check the background of an investment professional or firm.

Website: *www.finra.org/brokercheck*
Toll-free: (800) 289-9999

FINRA Investor Complaint Center—If you feel you've been treated unfairly.

FINRA Investor Complaint Center
9509 Key West Avenue
Rockville, MD 20850-3329

Website: *www.finra.org/complaint*
Fax: (866) 397-3290

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