

## How Variable Annuities Work

Ryan P. Smith

As with any investment, a variable annuity must be appropriate for an investor's needs. However, it is difficult for an investor to assess an annuity without understanding what a variable annuity is. This article will provide that understanding.

A variable annuity is a contract. In this contract an investor provides an insurance company (also known as the *issuer*) with a certain sum, and in return, the issuer promises to provide the investor (also known as the contract's *owner*) with a future income stream if the owner *annuitizes* the contract or certain other benefits. It is unique in that it offers both investment- and insurance-related features. In fact, it truly is "life insurance" in the sense that a variable annuity pays you as you live. Compare this with traditional life insurance, which pays your beneficiaries when you die.

Typically, an owner invests her assets in a variable annuity through a financial advisor (or *agent*). The agent receives a commission that is usually based on the amount of money that the owner invests. The owner can then allocate her assets – some products may offer the owner a "bonus" on those assets – within the variable annuity's fixed account or its variable subaccounts. Each subaccount offers a different investment objective, and in combination, can help the owner assemble an investment portfolio. Each subaccount also provides varying investment returns depending upon its investment objective and the overall markets' performance. These returns can be positive or negative. The variable annuity provider (also referred to as the *issuer*), in turn, invests the owner's subaccount investment in a mutual fund that corresponds with the subaccount's investment objective. The mutual fund and the subaccount often have similar names and are managed by the same investment advisor. Any growth is tax-deferred, which means that an owner does not pay income tax on any investment gains until she withdraws assets from the contract. This is often referred to as the *accumulation phase*.

Also during this accumulation phase, the owner has the opportunity to purchase additional insurance features. One is the so-called "living benefit." There are different names for this and, generally, the issuer will calculate the owner's future income stream upon annuitization using a certain minimum rate of return or the contract's actual value, whichever is higher. Another is the "death benefit." Although death benefits vary from contract to contract, as a general proposition a death benefit is usually the highest of some or all of the following values: the contract's value at death, the owner's net contributions, the owner's net contributions grown at a certain rate of return, or the highest account value at the contract's anniversary.

Issuers impose various fees and charges to pay for these benefits. Issuers charge an annual *mortality and expense risk charge* and an *administrative fee* to pay for the contract's insurance-related features and maintenance. In addition, issuers have additional charges for the optional benefits the owner selects. The owner also incurs



The Law Office of  
**RYAN P. SMITH, PLC**

The Law Office of Ryan P. Smith, PLC offers this article for informational purposes only. It is not legal advice and its distribution is not an invitation for, and its receipt does not form, an attorney-client relationship. The reader should seek counsel in his or her home jurisdiction.

annual *advisory fees* on the investments in the subaccounts. Finally, issuers may impose *surrender charges* for redemptions made within a certain number of years after purchase (typically up to 7 years).

The owner maintains control of the variable annuity contract, but there are other individuals also involved with the contract. The *annuitant* is the person who receives the annuity payments. He or she can be, but does not have to be, the same person as the owner. The *beneficiaries* are the individuals who will receive the death benefit.

Clearly there is a lot for an investor to understand in contemplating an investment in a variable annuity. However, among the key considerations for an investor in reviewing this product are:

- The variable annuity's guaranteed return is typically only applied if the owner converts her contract into an income stream. This benefit does not protect the contract from market fluctuations nor does it prevent it from losing value.
- Variable annuities may have fees and expenses that are not typically found in other investments.
- A variable annuity that offers a "bonus credit" may impose higher annual expenses and longer surrender periods than similar annuities that do not offer this credit.
- The owner pays income tax on any gains in the variable annuity at ordinary income rates. This rate is higher than the current capital gains rate, the rate at which gains in most other investments are taxed. In addition, in most circumstances, owners who are younger than 59½ at the time of a withdrawal must pay an additional 10% penalty tax.
- Assets inside of an IRA or other tax-qualified account already grow tax-deferred so there is little benefit to investing in a variable annuity with these assets absent a need for the annuity's insurance features.
- Some of the annuity's features may be unavailable due to the owner's age (sometimes seen with the death benefit) or limitations under state law.
- Variable annuities do not typically provide their owners with dividend or interest payments, unlike bonds or other fixed-income securities, because an annuity's owner owns interests in the annuity's subaccounts, not the underlying securities.

Having a fundamental understanding of a variable annuity is only a step. Obtaining solid investment advice from a qualified financial advisor is an integral part of the process. That said, you are invited to contact Ryan Smith at [ryan@ryanpsmith.com](mailto:ryan@ryanpsmith.com) or (804) 317-6832 if you have any questions or concerns about variable annuities.



The Law Office of  
**RYAN P. SMITH, PLC**

The Law Office of Ryan P. Smith, PLC offers this article for informational purposes only. It is not legal advice and its distribution is not an invitation for, and its receipt does not form, an attorney-client relationship. The reader should seek counsel in his or her home jurisdiction.