Should You Exchange Your Variable Annuity?

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If you have a life insurance or annuity contract, you may have been approached to exchange it for a new model, one with better or the latest features. You need to know that even though tax law makes the exchange income tax free and the new contract may sound better for you, you may be losing – not gaining – if you make the exchange.

FINRA is issuing this Alert because we have found investor confusion about variable annuity exchanges, and we have brought cases where investors were investing in variable annuities that were not suitable for them.

This Alert will give you information on how to determine if an exchange is right for you, and how you can find out what you need to know to make a smarter decision.

Some Background

You may know that an annuity is a contract between you and an insurance company where the company promises to make periodic payments to you, starting immediately or at some future time. You buy the annuity either with a single payment or a series of payments.

You should also know that annuity contracts come in two flavors: fixed and variable. Fixed means that the earnings and payout are guaranteed by the insurance company. Variable means that the amount that will accumulate and be paid will vary with the stock, bond, and money market funds that you chose as investment options. Unlike fixed contracts, variable annuities are securities registered with the Securities and Exchange Commission (SEC). Sales of variable insurance products are regulated by the SEC and FINRA.

Variable annuities may impose a variety of fees when you invest in them, such as: *surrender charges*, which you owe if you withdraw money from the annuity before a specified period; *mortality and expense risk charges*, which the insurance company charges for the insurance risk it takes under the contract; *administrative fees*, for recordkeeping and other administrative expenses; *underlying fund expenses*, relating to the investment options; and charges for *special features*, such as a stepped-up death benefit or a guaranteed minimum income benefit.

The Internal Revenue Service allows you to exchange an *insurance* contract that you own for a new life insurance or annuity contract without paying tax on the income and the investment gains earned on the original contract. This can be a substantial benefit. Because this is governed by Section 1035 of the Internal Revenue Code, these are called "1035 Exchanges."1

But this benefit comes with some important strings.

- The tax code says that the old insurance contract must be *exchanged* for a new contract – you cannot receive a check and apply the proceeds to the purchase of a new insurance or annuity contract.
- The tax code also says you can make a tax-free exchange from: 1) a life insurance contract to another life insurance contract or an annuity contract or 2) from one annuity contract to another annuity contract. You cannot, however, exchange an annuity contract for a life insurance contract.

Why Make a Section 1035 Exchange?

There are various reasons why a variable annuity contract holder may want to exchange an existing variable annuity contract.

- Many annuity contracts now offer premium – sometimes called bonus – credits toward the value of your contract, of a specified percentage ranging from 1-5% for each purchase payment you make.
- Also, in recent years, there have been new developments in annuity features, especially in variable annuities, that are valid reasons to consider an exchange. The number of investment options has increased. Less expensive variable annuity contracts have been created. Death and living benefits have been enhanced. Also, with the growth in the stock market in the 1990s, many insurance contract holders have wanted to take part in that growth. These are all valid reasons for considering exchanging one insurance contract for another.

Why *Not* Make a Section 1035 Exchange?

Generally, the exchange or replacement of insurance or annuity contracts is not a good idea, for a variety of reasons.

- "Bonus" or "premium" payments made to you are usually offset by the insurance company's adding other charges it makes to you.
- Other contract provisions, like surrender charges, eventually expire with an existing contract. However, new charges may be imposed with a new contract or may increase the period of time for which the surrender charge applies.

- You may also have to pay higher charges, such as annual fees for the new contract.
- You may not need the costly new features of the new contract.
- In many instances your broker is getting paid a higher commission for a variable annuity than he or she would for the sale of another securities product, such as a stock, bond, or mutual fund.

What You Should Watch For

You should exchange your annuity only when you determine, after knowing all the facts, that it is better for you and not just better for the person who is trying to sell the new contract to you.

Much of the sales growth of variable annuities in recent years has been from Section 1035 Exchanges. Even though some variable annuity enhancements have made variable annuities more attractive, you need to be sure that the exchange meets your objectives and benefits you. Variable annuities are long-term, retirement-oriented investment vehicles, and exchanging them may not benefit you.

> **Caution!** Variable annuity sales have dropped along with the decline in the equity marketplace. A recommendation for the exchange of an existing annuity contract for a new annuity contract may be the only way a salesperson can generate additional business. However, the new variable annuity contract may have a lower contract value and a smaller death benefit. As in any circumstances, 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.

Brokers or insurance agents recommending the exchange of an annuity contract must tell you important facts about the pros and cons of the exchange. Your broker or insurance agent is permitted to recommend such an exchange to you ***only*** if it is in your best interest and only after evaluating your personal and financial situation and needs, tolerance for risk, and the financial ability to pay for the proposed contract. This "suitability" obligation is based on FINRA rules.

Many states and brokerage firms require forms to reflect customer acknowledgment of a replacement transaction. These forms are to be signed by the annuity contract owner and the salesperson. These forms may provide a comparison of the features and costs of an existing contract to a proposed contract, and point out what you need to focus on when considering the exchange. You should review these forms closely.

Regardless of whether such forms are provided to you, you should specifically ask the person recommending that you exchange your variable annuity:

- What is the total cost to me of this exchange?
- What does the change in the surrender period or other terms mean for me?
- What are the new features being offered? Why do I need or want those features?
- Are those features worth the increased cost?
- Will you be paid a commission for the exchange, and if so, how much is it?

You should not sign any exchange form or agree to exchange or purchase an annuity until you study all of the options carefully, have all of your questions answered, and are satisfied that the exchange is better than keeping your current contract.

What Regulators Do to Protect You

FINRA and the SEC have been conducting a series of special sales practice examinations that have focused on the sales of variable contracts – variable annuities and variable life insurance.

These examinations have resulted in a number of cases that have found that some brokers and insurance agents recommended unsuitable variable products for their customers, and that the firms employing those brokers and insurance agents did not supervise them properly to prevent those unsuitable recommendations.

In addition, FINRA's examinations of its members selling variable contracts routinely investigate for inappropriate sales of variable contracts, including unsuitable variable contract exchanges or replacements.

Remember, however, that no matter how much regulators try to protect you, you are your own best protection by knowing what to avoid in the first place.

If You Have Questions or Complaints

If you have questions or complaints about an annuity contract exchange, you can contact FINRA, the SEC, your state securities administrator, and your state insurance commissioner.

1. The insurance industry uses the term "replacement" for a transaction in which a new insurance or annuity contract is to be purchased from the proceeds of an existing life insurance or annuity contract. A Section 1035 Exchange is a type of replacement transaction. Although the term "1035 Exchange" is often used to describe any form of replacement activity, especially regarding variable annuity replacement activity, technically not all replacements are Section 1035 Exchanges and as a consequence are not tax-free.