9 BEST ANNUITY STRATEGIES

A Continuing Education Presentation

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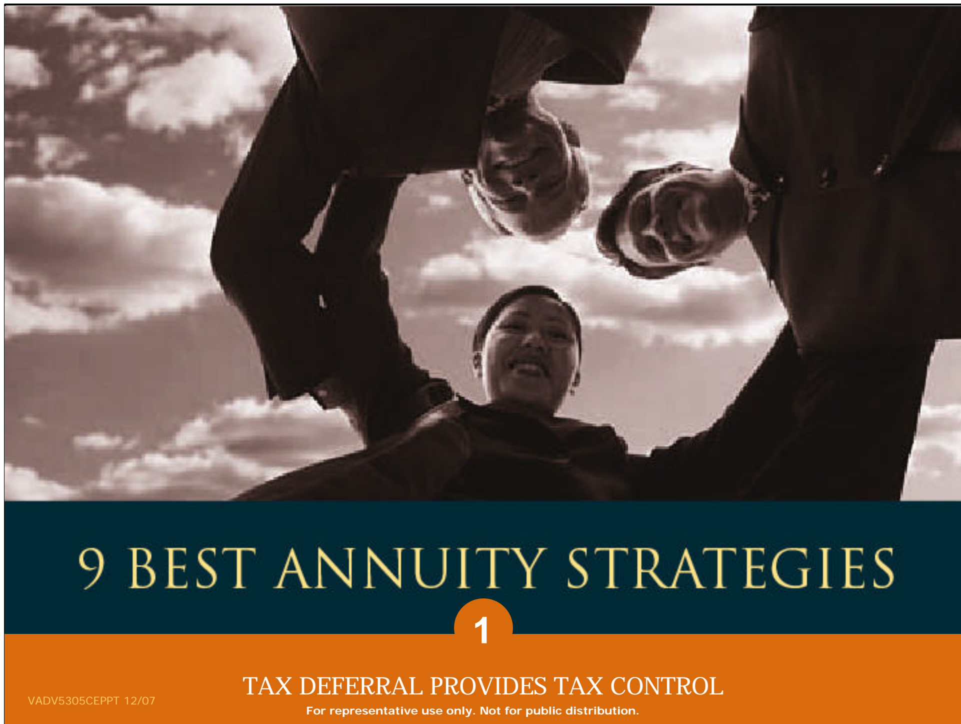

The first topic that we will discuss today is the issues surrounding tax deferral and tax control.

Tax Deferral Provides Tax Control

TIMING IS EVERYTHING!

One of the primary benefits of a non-qualified annuity is the ability to control the timing of taxation. The client decides when he/she will pay taxes.

• A primary benefit of a non-qualified deferred annuity is the ability to control the timing of taxation.

• “Control” means that the client pays no taxes until he or she takes a distribution. Because the client pays the non-qualified annuity premium with post-tax dollars, the client is not required to take a distribution until the contract matures. However, for annuities in qualified plans, the client pays premiums with pre-tax dollars and generally must begin taking minimum required distributions no later than April 1 of the year after they turn age 70½ . Qualified annuities also have annual contribution limits. Clients take distributions (access the accumulation of the annuity) via a full surrender of the contract, withdrawals from the contract, or annuitization of the contract.

• Most non-natural owners (for example, a corporation) must pay tax on the annual increase in the cash value of the policy, just as they would with any other taxable investment. There are certain exceptions to this rule, including trusts, that will allow some non-natural entities to receive deferral.

It is important to remember that individuals who are considering an annuity to fund a qualified plan such as an IRA or 401(k) should be aware that the tax-deferral feature of the annuity offers no additional value.

Tax Deferral Provides Tax Control

WAYS TO CONTROL TAXATION

- Annuitization
- Systematic Withdrawals
- Partial Withdrawals
- Surrender

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• Annuitization allows the client to further control income taxation by spreading the recognition of income over a period of years based on life expectancy or a period certain. A portion of this income stream is regarded as a return of principal and, therefore, not subject to taxation in a non-qualified annuity. The remaining portion of each payment is taxed as ordinary income.

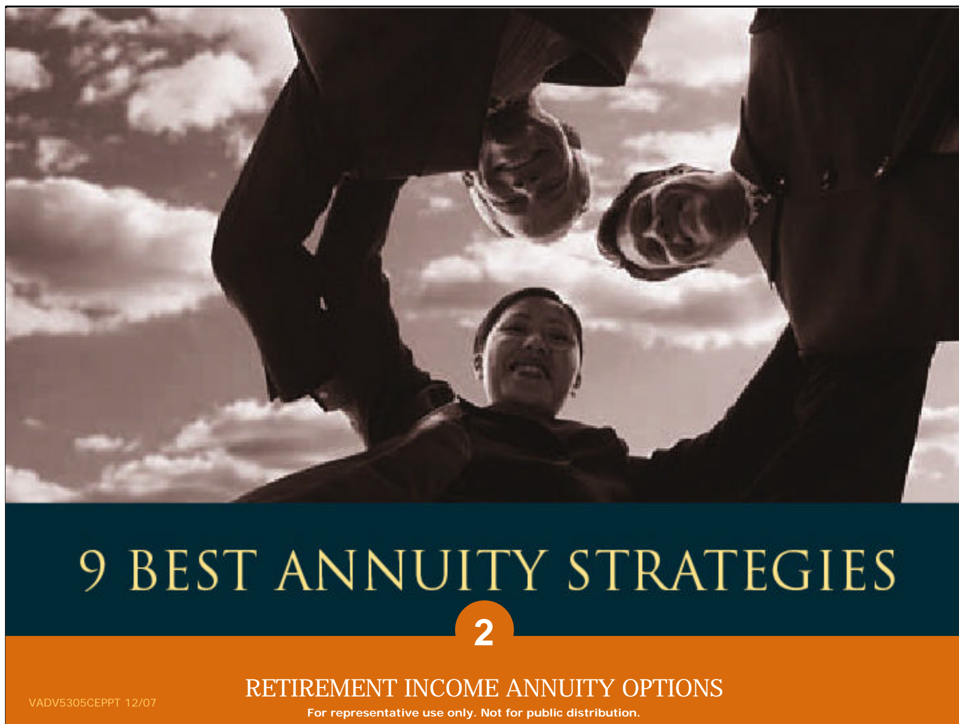
• Systematic withdrawal lets a client have money automatically withdrawn from the contract in equal, periodic payments. However, systematic withdrawals from non-qualified annuities do not receive the same favorable tax treatment as payments received under an annuitization option; systematic withdrawals are subject to the interest-out-first rule. This means that if any portion of the deferred annuity's value is attributable to earnings, a withdrawal will be considered to first come from those earnings before it is considered to come from premiums paid into the contract. Deferred annuity earnings are taxable as ordinary income when paid out of the contract, while amounts representing premiums are not income taxable. All withdrawals may be subject to withdrawal charges, recapture charges and excess interest adjustments.

• Partial withdrawals are permitted in many annuity contracts. The annuity may allow the policyholder to withdraw up to a stated percentage of the premium each year without incurring any contract withdrawal charges. Once the withdrawal charge period has ended, the owner may withdraw as much or as little as desired from the contract, up to the amount of their cash accumulation value. Of course, withdrawals may be subject to ordinary income tax, as well as an additional 10% federal income tax penalty if the contract holder is under age 59½.

• A contract holder can surrender his or her contract at any time. A surrender can incur withdrawal charges that can range from as high as 9% in the first year and typically decrease the longer the contract is in effect. If held long enough, no withdrawal charge is usually assessed. And again, withdrawals may be subject to ordinary income tax as well as a 10% federal income tax penalty if the contract holder is under 59 ½.

The various forms of withdrawals are subject to different rules and limitations across different annuity products. It is important to remember that most annuities are intended to be long-term investment vehicles **for retirement**, and you and your client should both understand the limitations and penalties involved with withdrawals from these products.

Let's pause here for a few seconds and discuss the phrase "ordinary income tax." This means that the income is subject to ordinary income tax rates. It is not given preferential tax treatment such as qualified dividends and long term capital gains.



The second topic that we will be discussing today is retirement income annuity options.

We will cover the advantages and disadvantages of:

1) Annuitization,
2) Systematic withdrawal and
3) Pre-59½ distributions with annuities.

Retirement Income Annuity Options

ANNUITIZATION ADVANTAGES

- Guaranteed income for life[1]
- Payments include return of principal
- May provide an inflation hedge
- Multiple investment options with many annuities

[1] All guarantees are backed by the claims paying ability of the issuing insurance company.

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First, let's discuss annuitization.

• Advantages include:

• Guaranteed income for life.

• Income reflects partial return of principal for a non-qualified annuitization option, and therefore only a portion of each payment is taxable.

• Depending on options selected within the contract, a variable annuitization option may provide a hedge against inflation.

• Multiple investment options are provided with many annuities.

Of course, we must also discuss the disadvantages of using annuitization to provide income.

Retirement Income Annuity Options

ANNUITIZATION DISADVANTAGES

- Irrevocable
- No liquidity
- Income could decrease in a down market*
- No death benefit after "period certain" guarantees expire

* Variable annuitization only

The disadvantages include:

• Irrevocable election—In general, once the annuitization period starts, the client cannot make changes to their election.

• No liquidity—Accessing money may require the payment of withdrawal charges.

• Income could decrease in a down market—If your client chooses variable annuitization, the client may lose money in a down market.

• No death benefit after "period certain" guarantees expire.

Retirement Income Annuity Options

SYSTEMATIC WITHDRAWAL

- Alternative to annuitization

ADVANTAGES

- Client maintains asset control
- Distributions can be modified
- Inflation protection
- Death benefit proceeds for beneficiaries
- Access to additional income

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8

With respect to systematic withdrawal, the advantages include:

- Client maintains asset control
- Distributions can be modified
- Inflation protection because of continued growth potential of assets
- Death benefit proceeds for beneficiaries
- Access to additional income until assets in contract are gone

Retirement Income Annuity Options

SYSTEMATIC WITHDRAWAL

- Alternative to annuitization

DISADVANTAGES

- Does not guarantee income for life
- Taxation. No exclusion ratio

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The disadvantages of systematic withdrawal are:

• Does not guarantee income for lifetime
• Taxation. No exclusion ratio

Retirement Income Annuity Options

PRE-59 ½ DISTRIBUTIONS

IRC 72(t) and IRC 72(q)

- Avoids the 10% IRS penalty
- Avoids annuitization
- Maximum distributions NOW
- Flexibility later

Source: IRS Section 72(t), 72 (q)

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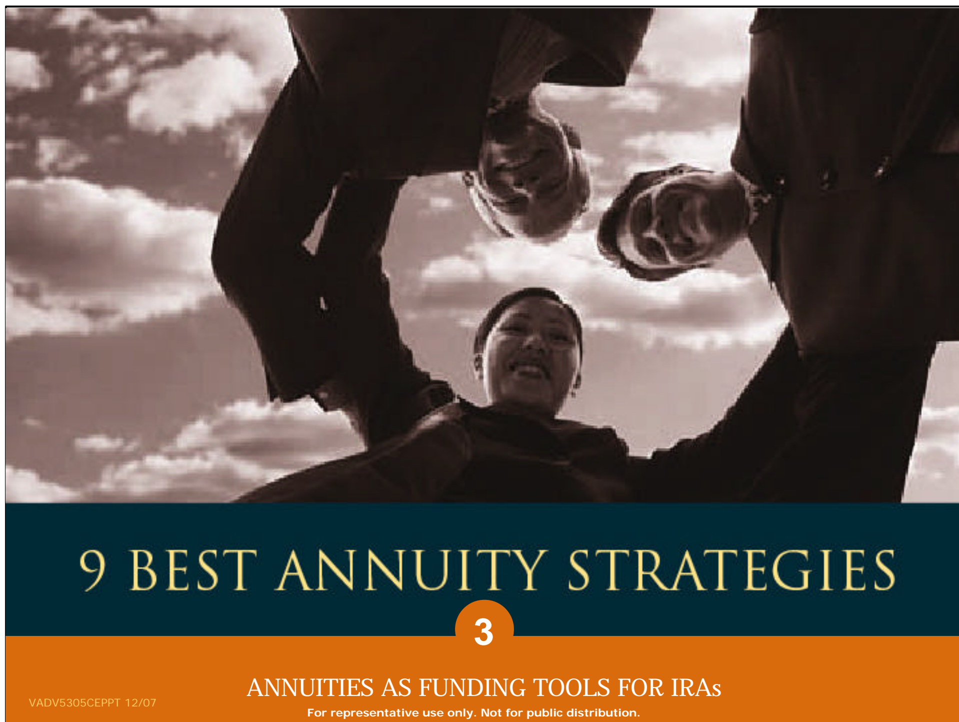
Now let's discuss pre 59 ½ distributions. You may be familiar with Internal Revenue Code provisions 72(t) and 72(q). In fact, these provisions are very detailed and an entire continuing education seminar should be dedicated to the specifics. However, a summary of the basics that you must know is that these provisions:

• Avoid the IRS 10% penalty if Substantially Equal Periodic Payments (SEPPs) are withdrawn based on life expectancy using a 120% midterm applicable federal rate of return. Once the distributions begin, the account owner must take distribution for five years, or until the owner is 59½, whichever period is longer. The owner must stick to the payment schedule – if the periodic payments are modified, other than by reason of death or disability, the 10% penalty, plus interest and possibly additional underreported tax penalties will be imposed on all payments previously received. Once the substantially equal periodic payment period is over, the owner is free to change the payment amount, or stop withdrawing money altogether.

• Avoid annuitization of the contract.



The third topic we will be discussing today is the opportunity of including deferred annuities as a funding tool for IRAs.

FINRA states, "Variable annuity sales should only be made when other benefits of a variable annuity, such as a death benefit or annuity payment options, support the purchase." By extension, this should apply to all annuities. A representative must explain to the customer the cost and features of the annuity. Also, you must compare and contrast the annuity with other suitable investment choices that can be purchased.

Obviously, an annuity is not appropriate in every circumstance. But, in some, it can be an appropriate choice.

Source: NASD News Release, December 4, 2002.

Annuities as Funding Tools for IRAs

The concern about using an annuity to fund an IRA

COMMON CONCERN

- Using an annuity inside an IRA is redundant and you are paying for a feature that you don't need.

KEEP IN MIND

The tax deferral of an annuity is part of the tax code, and is not a consideration when choosing to place an annuity in a qualified plan.

Annuities in IRAs provide death benefits and guarantees[1] other products cannot.

[1] All guarantees are backed by the claims paying ability of the issuing insurance company and do not apply to a variable annuitiy's separate account or its underlying investments.

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• One concern about using an annuity in an IRA is the issue that you are "sheltering a shelter." It is important to understand the tax-deferred nature of an annuity. In general, tax deferral is one of the key advantages of an annuity, although it is not an additional benefit when an annuity is used as a funding vehicle for an IRA. In fact, it is not and should not be a consideration. Annuities offer other benefits that many other IRA funding tools don't. For instance: guarantees, death benefits, and expenses that are guaranteed not to increase above a specified level.

• When you recommend the purchase of an annuity for an IRA, you must disclose to your client that the tax-deferred nature of the annuity offers no additional benefit. Make them aware of the other benefits the annuity offers, and compare and contrast them with other appropriate, suitable alternatives.

Annuities as Funding Tools for IRAs

WHAT DOES AN ANNUITY HAVE THAT OTHER IRA FUNDING VEHICLES DON'T?

- Guarantees [1]
- Flexibility
- Management by a single provider
- Can provide income you can't outlive

[1] All guarantees are backed by the claims paying ability of the issuing insurance company and do not apply to a variable annuity's separate account or its underlying investments.

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There are many differences between annuities and other investments that can be chosen to fund IRAs, which include, but are not limited to: guarantees, flexibility, that they are managed by a single provider, and that they can provide income you can't outlive.

The guarantees of an annuity are designed to protect the client and beneficiaries through optional living and death benefits. Optional living benefits are often offered for variable annuities at an additional cost. They help guarantee that either withdrawals or annuitized distributions do not decrease below a certain level due to fluctuations in their subaccount performances. A standard death benefit is usually included for no additional cost, and guarantees that if you should die before you withdraw or annutize your annuity, your annuity's beneficiaries will receive the higher of the account value or a different amount specified in the deferred annuity (such as the amount you contributed to the annuity, less withdrawals). In many variable annuities, the death benefit can increase over time. Additional death benefits may also be offered for additional costs, and help to ensure that beneficiaries receive increased or stepped-up benefits.

Today's annuities tend to be more flexible than they were in years past. With more companies offering unbundled annuities, the client is better able to design a policy that meets their needs and objectives, all within a single contract, and with a single manager that has a number of investment choices, so it is easy to exchange your sub-account and diversify your portfolio.

The annuitization option is useful for individuals who are looking for a steady stream of income over a specified period. There are different types of options and payment modes. For instance: The client can decide on a set amount of money that will not change, which is called "fixed annuitization." The rate of return is usually based off of the current interest rates and the duration of the payments. Or the client can choose to have his payment vary depending on the performance of the underlying sub-accounts. This is referred to as "variable annuitization." Based off of the performance of the underlying modal units invested in the individual sub-accounts, it will cause the payments to fluctuate up or down, in turn causing the distribution amounts to be larger or smaller. The periods are usually done for a set number of years ranging from 5 to 30. Or it is set up over the annuitant's life expectancy. This way, the client cannot outlive their money.

Of course, all annuities have different limitations and expenses. Both of these must be clearly explained and considered before investing. For example, guarantees are only as good as the company making them. And income options may have different cost structures for different annuities. A product must be closely monitored for suitability before making an investment recommendation.

Let's take a look at some of the investment alternatives a client can consider for funding an IRA.

Annuities as a Funding Tool for IRAs

ANNUITIES AND OTHER INVESTMENT OPTIONS

- CDs and Annuities
- Mutual Funds and Annuities
- Stocks and Annuities
- Bonds and Annuities

Charges, expenses and risks vary with each investment vehicle and may include withdrawal charges.

CDs may be FDIC insured and offer a fixed rate of return. Should interest rates rise, the value of the bond will fall, whereas the value of the CD will remain fixed until maturity.

Annuities have restrictions and limitations. When considering an annuity in a qualified plan, the tax deferral feature offers no additional value.

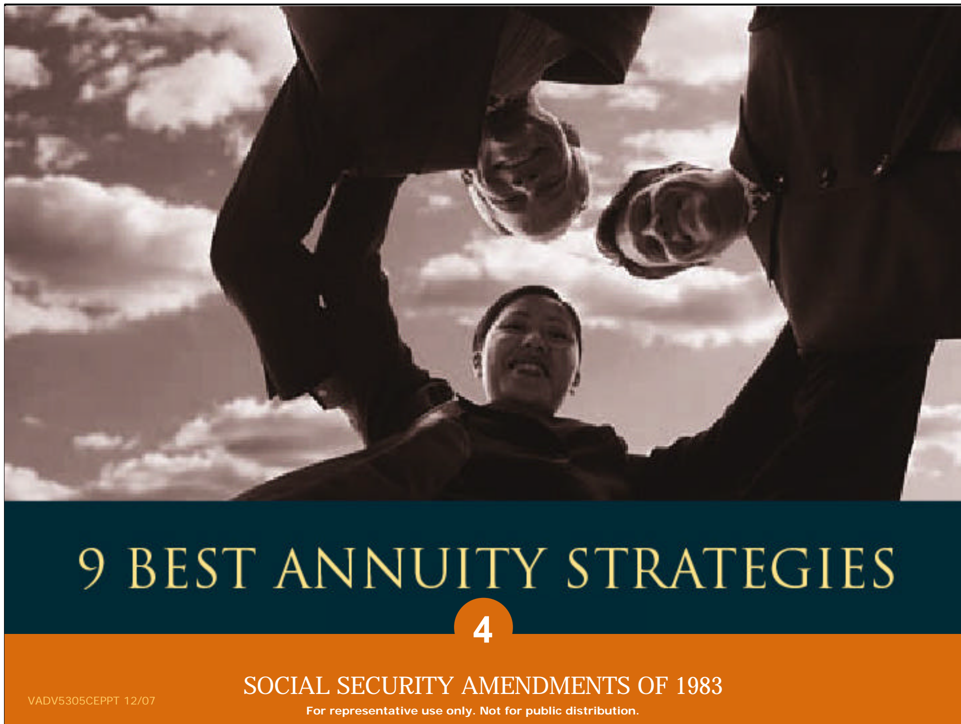
CDs may offer the safety of FDIC insurance. However, they typically offer relatively lower yields compared to other types of investments that are subject to interest rate risk, and provide limited access and liquidity because they rarely allow any withdrawals without penalty during the holding period. Annuities may provide opportunity for higher returns, though they are not insured by any government agency, and may be subject to interest rate, market risk, or both. Annuities are typically considered long-term investments but, as we've discussed, most allow partial withdrawals in the event your client needs access to their money.

Many qualified professional money managers offer mutual funds. They offer similar benefits and risks to the variable investment options in an annuity contract, including professional money management and diversification. Of course, the death benefits and guarantees offered by many annuities come with an additional cost, and you will want to review these costs with your clients before making a recommendation.

Stocks and bonds can also be used to fund an IRA. However, selecting individual stocks and bonds, and not relying on professional money management, can be risky. It is also very difficult for a typical investor, unless they have a lot of money, to adequately diversify their portfolio by selecting individual securities.

IRAs are tax-deferred vehicles, however, when distributions are taken, they are taxed as ordinary income regardless of the type of investment. Because of this, special taxation incentives of long term dividends and capital gains in CDs, stocks and mutual funds are not applicable when they are held in an IRA. There are situations where non-deductible IRA contributions can be deducted as a tax loss.

An annuity offers the death benefit and guaranteed income options we've mentioned.



The fourth topic that we will be exploring is the Social Security Amendments of 1983.

Social Security Amendments of 1983*

- A portion of Social Security benefits may be subject to income taxation.
- Your clients need to know their "Provisional Income."
- How much income they get from other sources will determine how much of their Social Security will be taxed.

*Source: Social Security Advisory Service (http://www.ssas.com/tax.html).

Social Security benefits can now be subject to taxation when the client's provisional income exceeds $44,000 (for joint filers) or $34,000 (for unmarried filers).

How much of your client's Social Security benefits may be subject to taxation depends on their provisional income, which I will define in a moment.

Depending on their amount of provisional income, none of their benefits may be subject to tax, or up to 85% of their benefits may be taxable.

Social Security Amendments of 1983

PROVISIONAL INCOME

In general, provisional income equals adjusted gross income plus tax-exempt bond income plus one-half of Social Security benefits.

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So what is “provisional income”?

For most taxpayers, the provisional income calculation includes the sum of adjusted gross income (AGI), tax-exempt interest and one half of the Social Security benefits.

Social Security Amendments of 1983

PROVISIONAL INCOME

For a Married Couple

- Provisional income between $32,000 and $44,000: Social Security can be taxed up to 50%
- Over $44,000: up to 85% of benefits are taxable

For a Single Person

- Provisional income between $25,000 and $34,000: Social Security can be taxed up to 50%
- Over $34,000: up to 85% of benefits are taxable

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If a married couple has provisional income between $32,000 and $44,000, Social Security benefits can be taxed up to 50%. If their provisional income is over $44,000, up to 85% of benefits are taxable.

If a single person has provisional income between $25,000 and $34,000, Social Security benefits can be taxed up to 50%. If his or her provisional income is over $34,000, up to 85% of benefits are taxable.

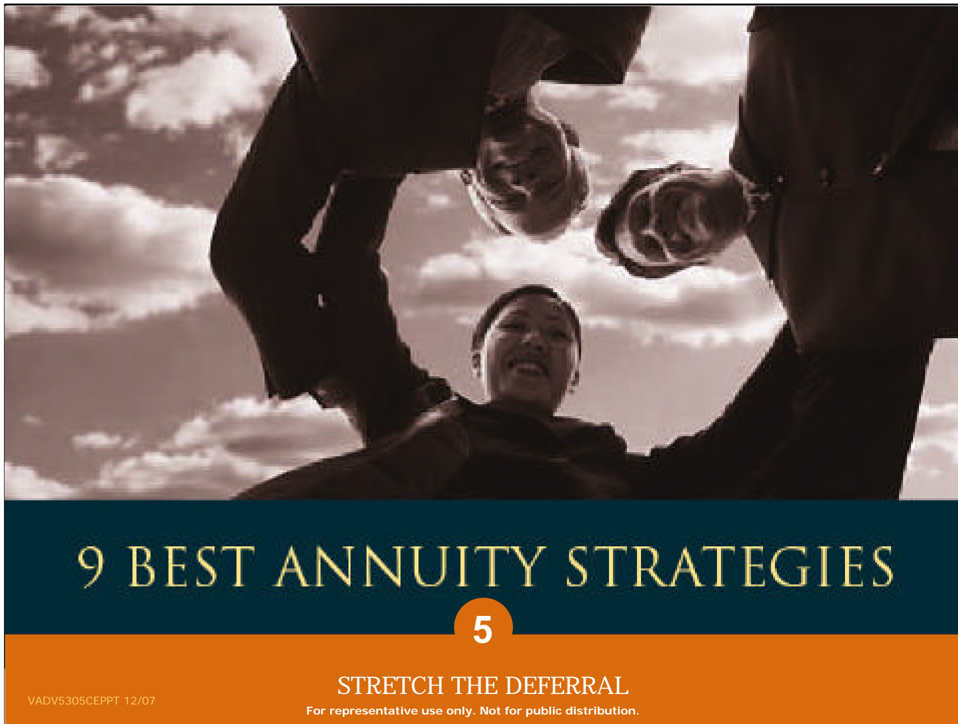
If the client's income is below $25,000, there is no Social Security benefit taxation.

Social Security Amendments of 1983

THE ROLE ANNUITIES CAN PLAY

- Undistributed deferred income is not included in provisional income.
- Shifting at least a portion of assets from taxable investments or tax-exempt bonds to annuities can potentially lower an individual's provisional income.
- This can reduce or eliminate income tax paid on Social Security benefits.

The cash accumulation inside an annuity contract is not included in the calculation of a senior's income until the senior accesses the funds. In contrast, the income from taxable investments or tax-exempt bonds adds to a clients' provisional income and may change the taxable nature of their Social Security benefits. Because of the withdrawal charges and limitations of an annuity, it is important to discuss and determine the liquidity needs of the senior. If lack of liquidity is a concern, then the annuity is not suitable. If an annuity is suitable, one benefit is that the senior may be able to control, and possibly reduce, the amount of Social Security benefit taxation.



As stated earlier, a primary benefit to a non-qualified deferred annuity is tax deferral. Annuities have the potential for growth without taxation until distribution. But what happens at the death of the annuitant/owner? Traditionally…

Stretch the Deferral

Standard Options for Beneficiaries

Tax-Deferred Growth

CASH OUT

Flexibility

Tax-Deferred Growth

TRADITIONAL LIFE ANNUITIZATION

Flexibility

Source: IRS Section 72(s)

"Standard" death benefit options include:

1. A lump sum distribution that needs to be distributed within five years; or
2. Annuitization for life.

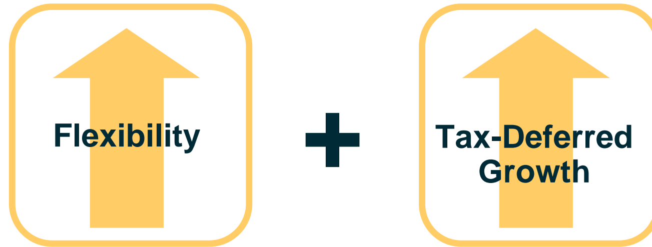
Both of these options have pros and cons–with the lump sum option, the beneficiary has the flexibility with cash in hand and total liquidity. They can spend or reinvest the money as they wish. The problem is, receiving the entire taxable portion of the contract within one to five calendar years can be a very expensive choice, due to the taxes that must be paid over such a short period of time.

With the annuitization option, they have the ability to spread the taxable portion over the years that money is distributed. This can be very beneficial from a tax standpoint, but can also be dreadful because of the lack of liquidity. Typically, once an annuitization option is selected and payments commence, the annual amount of income is irrevocable and unchangeable. This amount of money is all the beneficiary has access to. The beneficiary has no right to take out more or less. That said, certain companies have enhanced death distribution options. Such as:

Stretch the Deferral

The Best of Both Worlds

INCOME FOR A SPECIFIED PERIOD



Income for a Specified Period (ISP) is a "stretch" option that can be utilized for non-qualified money. Under this option, a beneficiary can elect to specify and receive an income stream ranging from 5 to 60 years (may vary by issuer's company), as long as the period does not exceed the beneficiary's life expectancy. In the event that the beneficiary dies prior to receiving the specified number of payments, the beneficiary's beneficiary can continue to receive the periodic payments previously established by the original beneficiary. At any time, the beneficiary or beneficiary's beneficiary may elect to receive a lump sum which would be based on the discounted present value of the remaining guaranteed payments. Because ISP income is considered annuitization, the income stream receives favorable tax treatment. The ISP option may provide beneficiaries with continued tax deferral on the remaining assets and gives them the flexibility to cash out at any time.

Less than 10% of annuity contracts are ever annuitized. Often producers think this won't be for their clients because they may equate annuitization with a loss of flexibility on their clients or their clients' beneficiaries part, or loss of income on their part. This doesn't have to be the case. Again, finding a company that provides the most flexibility in its distribution options, while keeping the producer in mind, can have some very positive implications.

Source: Advisor Today: *Annuity Investing and Proper Contract Structuring Considerations*, Paul M. Leagues, CFP, March, 2001

Stretch the Deferral

Income for a Specified Period

- Income for a Specified Period–annuitization extended up to 60 years (as long as it doesn't exceed beneficiary's life expectancy)
- Beneficiary's beneficiary can continue stretch until the end of previously established period certain
- Ability to commute value at any time, but cannot increase the amount
- Exclusion ratio applies

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ISP has many features that go above and beyond typical annuitization.

First, it allows for the opportunity to extend the stream of income up to the lesser of 60 years or life expectancy, although some companies offer annuitization for periods not exceeding 20 to 30 years.

Second, because the income is for a specified period, there is no concern with the beneficiary's beneficiary being forced to take a lump sum distribution. The payment will continue throughout the entire specified period. Now this doesn't mean that the beneficiaries are locked in. This brings me to the third important feature:

The ability to commute the value of the annuity. This allows the beneficiaries a way out of the income stream.

Also, in contrast to taking withdrawals out of a non-qualified annuity in the accumulation phase, which are taxed Last-In-First-Out (LIFO), every payment consists of not only the gain in the contract, but also a return of basis, which is excluded from taxation. This is known as the "exclusion ratio" and allows for a more tax-efficient way to receive an income stream.

Keep in mind, actual annuity earnings, investment returns, withdrawal charges and their duration, as well as the commission, will differ among different annuities, and depending on the investments selected, an investor can lose money over time.

Stretch the Deferral

Irrevocable Systematic Withdrawals

Minimizes taxes

- Distributions made over beneficiary's life

Generates flexible income

- Must take a minimum amount each year
- May take additional amounts when/if needed

Provides for heirs

- Ability to name a new beneficiary

Beneficiary control

Source: IRS Private Letter Ruling 2001 SI 038

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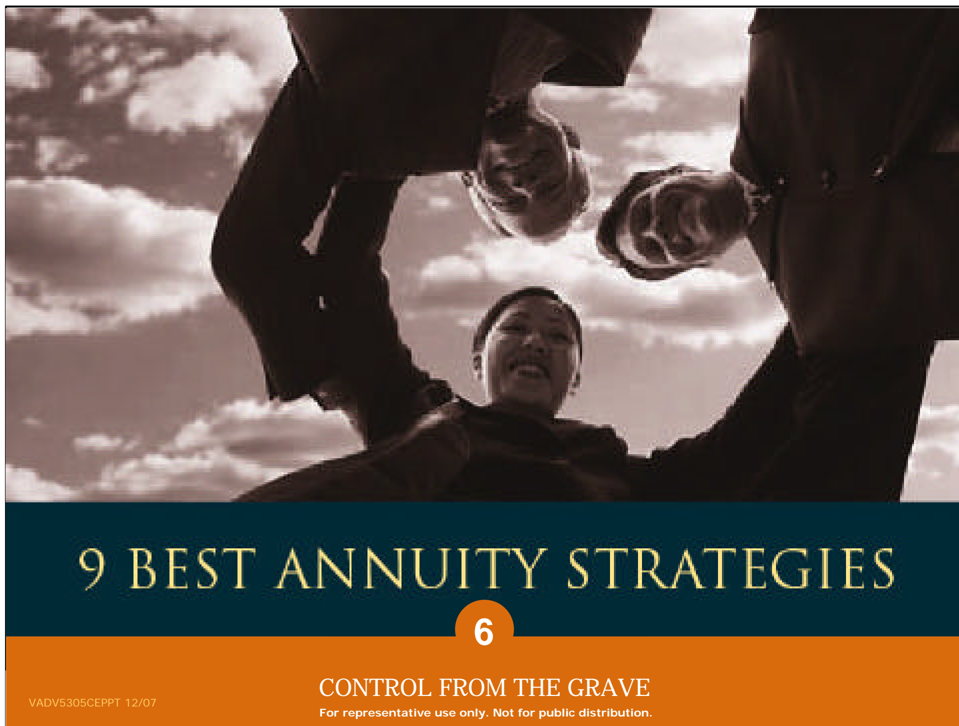
Irrevocable systematic withdrawals are another distribution strategy that allows beneficiaries of non-qualified annuities to "stretch" death distributions.

By taking the death benefit under the systematic withdrawal option, the beneficiary is able to take distributions over his or her life expectancy. This is calculated using IRS Table I life expectancy on a non-recalculated basis. Because the beneficiary's life expectancy is typically much longer than the five-year default option, the beneficiary is able to control his or her taxes, due to the continued benefit of tax deferral on amounts that have yet to be withdrawn.

Because it is a systematic withdrawal option, and not annuitization, the beneficiary is afforded income flexibility. Generally, one trade off for this flexibility is that the distribution is usually taxed on a Last-In-First-Out basis (LIFO). Generally, the trade off for selecting systematic withdrawal over annuitization is the taxation issue. While the beneficiary must take a minimum amount of distribution each year to satisfy IRS requirements, the beneficiary is always allowed to take more income if and when a need arises.

The non-qualified stretch option provides for your clients' heirs, and gives them the ability to name a new beneficiary who may receive the remaining amount in a lump sum upon the original beneficiary's death. The stretch option is also used as a platform to control beneficiaries' access to the funds. Of course, there is no guarantee of an annuity's performance over time, and depending on the investment selected, one could lose money over time.

When you work with your clients, you will want to explain that current tax code laws are subject to change, and that the performance of the underlying product, over time, as well as any estate tax requirements, can significantly change the amount of money available for heirs.

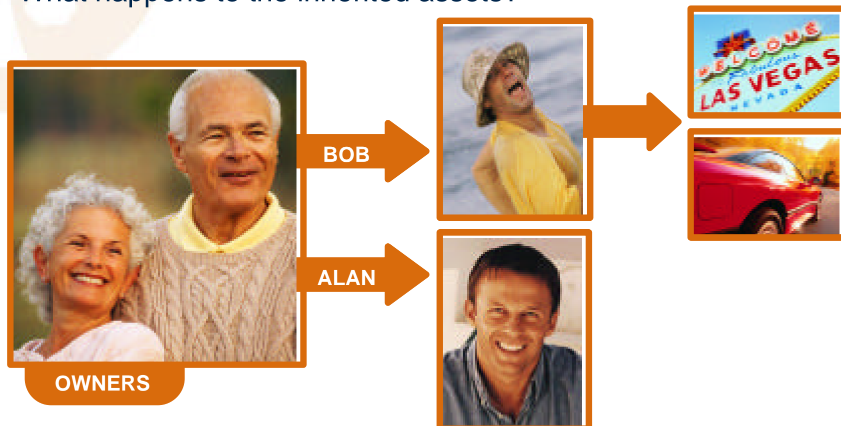


Using Control from the Grave allows for account holders to predetermine how and when their beneficiaries will receive the death benefit.

NOTE: Not exclusive to Jackson^{SM}. Other annuity carriers have this, but it is somewhat rare in the annuity world.

Control from the Grave

What happens to the inherited assets?



This illustration is purely hypothetical.

Let's consider a hypothetical example:

Often, children within the same family somehow end up with different lifestyles, different spending patterns, and varying goals for their lives…not only different from their parents, but also from their siblings.

Talking Points:

Let's take a look at Joe and Karen and their family:

• How many of you know children like Bob? Almost seeming as if they're waiting for their folks to die so they can get their hands on their parents' money. They, like Bob here, have their eyes on the latest sports car, or are hoping to "strike it rich," and increase the size of their inheritance.

• Or, many may be like Alan. Tried and true. Conservative. Successful, with no intention of using any of their inheritance to generate a more lavish lifestyle for themselves.Alan has helped his parents increase the size of their estate, and would be equally as devastated to see it gone within days through careless spending.

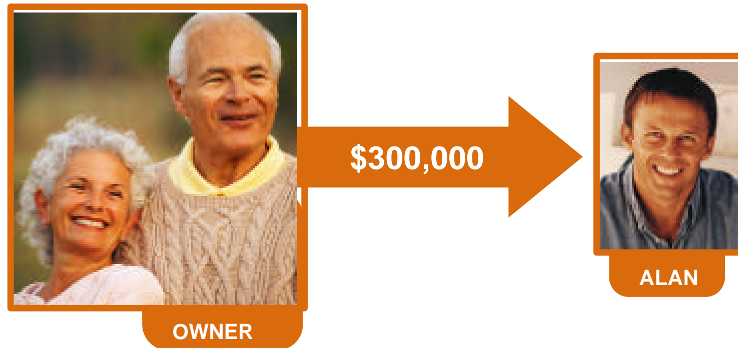
Transition:

But, what do Joe and Karen want for their children?

Control from the Grave

Hypothetical Example: No election

BENEFICIARY TAKES A LUMP SUM



This illustration is purely hypothetical.

For Example:

Take Joe as the owner and Alan as the beneficiary. With Alan, Joe elects to allow Alan to choose a single lump sum distribution (number one) method, therefore, Alan can elect to receive his death benefit proceeds in a single lump sum. <Other possibilities> <Joe may want to utilize the NQ Stretch that we discussed previously in this situation.>

Talking Points:

- Since Joe knows that Alan is responsible and fully capable of making appropriate decisions with his money, whether it's earned or inherited, Joe decides not to restrict Alan's access to the death benefit.
- Upon Joe's death, Alan decides to take the lump sum option.
- While the lump sum may not be the most tax-advantaged option Alan could have elected, Joe left that decision up to Alan. Although this entire amount may be fully taxable as income in the year it is received, Joe believes that Alan can invest prudently.
- Joe can divide his assets according to how each child will spend the assets.

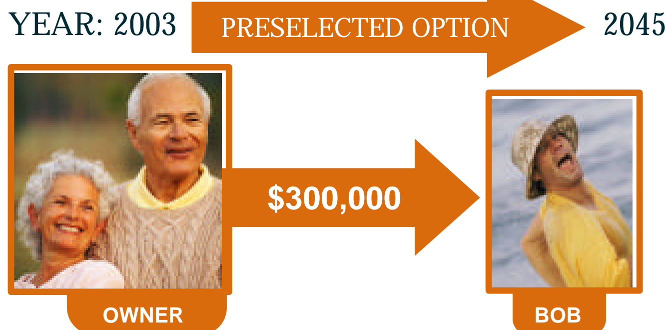
Transition: So what about Bob?

Control from the Grave

Hypothetical Example

IRREVOCABLE SYSTEMATIC WITHDRAWAL

BENEFICIARY: Joe preselected an ISW Death Benefit Election option for Bob.



Available with some insurance companies. Check with a provider for specific details. This illustration is purely hypothetical.

For Example: Because Joe is confident that Bob will throw his money away very quickly, Joe decided to place a restriction on Bob's portion of the death benefit, so:

Talking Points:

• Prior to Joe's death, he utilized a Preselected Death Benefit Election option and restricted Bob's death benefit payout to an Irrevocable Systematic Withdrawal option.

• Joe sets up a stream of income for Bob.

• Bob cannot change this stream, since it is pre-set and pre-determined by Joe until the age restriction is lifted as indicated on the form.

Transition:

By electing the Irrevocable Systematic Withdrawal option, Joe reduces the chances of his hard-earned income disappearing upon his death because of careless spending by the beneficiary.

Control from the Grave

Future Generations Benefit

YEAR: 2003 ANNUAL ALLOWANCE 2045

BENEFICIARY: Joe preselected an Irrevocable Systematic Withdrawal Death Benefit Election option for Bob. Bob's beneficiaries may receive remaining amounts.

This illustration is purely hypothetical.

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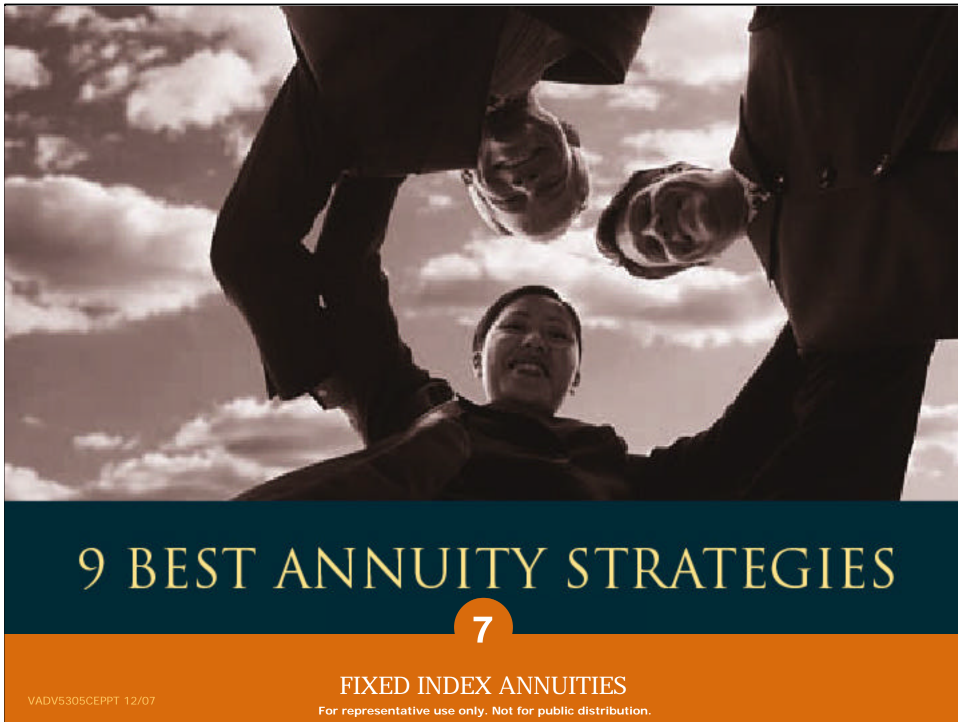
For Example:

Joe pre-selects an Irrevocable Systematic Withdrawal Death Benefit Option in order to ensure that Bob is provided an income stream.

Talking Points:

- No nice cars and wild trips. Instead, Joe provides Bob with an annual allowance.
- Joe sets this up in a period certain so Bob's beneficiaries are not hurt if Bob dies prematurely.
- Joe is then able to decide if Bob should receive the minimum amount for life, or perhaps place a restriction only until he reaches a (hopefully) more mature age, say 50.
- Joe is able to "control from the grave" by restricting the timing and amount of income Bob will receive from the death benefit.

Transition: While Bob may be disappointed that he may have to wait to buy that Porsche or visit Las Vegas, Joe can rest assured that Bob will have the opportunity to use his death benefit wisely.



The seventh topic we will be discussing today is the fixed index annuity (FIA). The fixed index annuity is a fixed annuity that provides clients upside potential to earn additional interest by linking their returns to a stock index. The FIA provides clients downside protection with a guaranteed rate of return over the period selected.

Fixed Index Annuities

What is a Fixed Index Annuity (FIA)?

DEFINITION:

A fixed index annuity (FIA) is a long-term fixed annuity which guarantees the principal if held to term, earns a guaranteed minimum interest rate, and offers upside potential based on the performance of a market index, if held to term. FIAs do not participate in any equity investments, and are not considered securities.

Fixed index annuities are known as equity index and fixed annuities in Oregon.
Guarantees are backed by the claims-paying ability of the issuing company.
Source: Index Compendium, *indexannuity.org.*

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The definition of a fixed index annuity (FIA) is:

(Read Slide)

A fixed index annuity (FIA) is a long-term fixed annuity which guarantees the principal if held to term, earns a guaranteed minimum interest rate, and offers upside potential based on the performance of a market index, if held to term. FIAs do not participate in any equity investments, and are not considered securities.

You may have previously heard fixed index annuities also called equity index annuities or equity-linked index annuities. However, these names could be potentially confusing to clients, who may associate them with types of investments, such as equities or variable annuities, which they are not. The term fixed index annuity is a more appropriate name for this type of fixed annuity, rather than "equity" index annuities – since they are not equities.

Even though FIAs are not securities, they participate in a percentage of any increase in a market index. Should the index they are linked with perform poorly, however, even negatively, fixed index annuities provide a guaranteed minimum rate of return (which equity investments do not), typically as long as they are held until the end of their term. Another way of looking at how FIAs work is that, in exchange for the guarantee of principal, if held to term, along with the guaranteed minimum rate of return, FIAs do not benefit from the total increase in the market index they are linked with. So, FIAs receive less of the upside, but on the other hand, they do not participate in any downside, because the FIA policyholder does not experience any market losses. The insurance company assumes all of the market risk.

If the FIA is not held to term, the principal may not be guaranteed and the contract holder may not receive the entire principal back.

Source: Index Compendium, *indexannuity.org*

Guarantees are backed by the claims-paying ability of the issuing company.

Fixed Index Annuities

What is a Fixed Index Annuity (FIA)? (Continued)

BASIC CHARACTERISTICS

FIAs are FIXED ANNUITIES.

- Long-term vehicles intended for retirement.

Offer earnings that are linked to the increase in a market index.

- FIAs are NOT investments in equities.

Great majority of FIAs are NOT registered products.

- FIAs are fixed insurance instruments, not securities.
- Regulated by insurance departments, not FINRA.

Provide guaranteed minimum rate of return, if the index they are linked with performs poorly.

- Principal protection from market loss.

Guarantees are backed by the claims-paying ability of the issuing company.

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FIAs, which again are fixed annuities, also offer most, if not all, of the advantages of traditional fixed annuities, including principal protection, if held to term, guaranteed lifetime income options, death benefit, avoidance of probate, as well as tax-deferral on earnings – the earnings, like all other annuities, are taxed as ordinary income when distributed, and could also be subject to a 10% federal tax penalty if withdrawn before the policyholder reaches 59½ years old. And, like most annuities, there are generally charges for any withdrawals that are taken or if surrendered before term end. Many Fixed Index Annuities on the marketplace do, however, allow a policyowner to take a certain amount of withdrawals free of withdrawal charges, within a specified amount of time during the accumulation stage (typically annually), or they may charge upfront basis points for this privilege. Additionally, many FIAs provide free withdrawals or surrenders in the event a policyowner is diagnosed with a terminal illness, or confined to a nursing home or hospital. In a nutshell, Fixed Index Annuities are long-term savings vehicles intended for retirement.

Even though they offer earnings that are linked to the increase of a market index, Fixed Index Annuities are NOT investments in equities.

A very small number of FIAs are registered with the SEC, but they are a tiny minority. The great majority of FIAs are NOT registered because most are NOT considered to be securities, but fixed insurance instruments. They are regulated by insurance departments, not FINRA. Remember – a Fixed Index Annuity, unlike securities, is an insurance contract with upside potential that guarantees a minimum rate of return and protects its principal from any market loss.

Guarantees are backed by the claims paying ability of the issuing company.

Fixed Index Annuities

Typical Fixed Index Annuity Features

Market Index

- FIA earnings are linked to a specified market index; ie S&P 500.

Index Participation Rate (IPR)

- The percentage of any index gains that an FIA may receive.

Minimum Rate of Return (or Floor)

- Minimum guaranteed amount credited to a policy.

Maximum Credited Interest (or Cap)

- Maximum percentage increase that can be credited.

Examples are purely hypothetical and for illustrative purposes only. Not representative of the future performance of any particular investment or product. Past performance is no guarantee of future results. Guarantees are backed by the claims-paying ability of the issuing company.

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Some typical features of fixed index annuities include:

Market Index:

FIA earnings are linked to a specified market index; ie S&P 500.

Index Participation Rate:

The Index Participation Rate, or IPR, is the percentage of any index gains that a fixed index annuity may receive. For example, if an FIA's IPR were 60%, the FIA would benefit from 60% of the index's increase. Using a 60% IPR, if the index increases by 15%, the FIA would hypothetically benefit from 9% of the gain. *Example:* Index gain multiplied by the IPR equals the FIA credited interest; or (15% index gain x 60% IPR = 9%). It is important to realize that many FIA companies guarantee the IPR will never change during the FIA's contract term. If the IPR is not guaranteed through the FIA's term, the IPR could be reset at a higher or lower rate.

Minimum Rate of Return, or Floor:

This is the guaranteed minimum rate of return that is credited to an FIA policy, in the event that the index the FIA's earnings potential is linked to performs negatively.

Maximum Credited Interest, or Cap:

This is the maximum percentage increase that can be credited on an FIA policy. For example, if the index increases by 15%, and the contract has a 10% Cap, the increase will be limited to 10%. The Cap may vary depending on the length of the term (for example, a higher Cap for a longer term). And also, the Cap may reset annually and may be subject to change. Most Caps are set annually, while others may be set for the term of the contract. Still other Caps may be set for a two- or three-year period.

Fixed Index Annuities

Typical Fixed Index Annuity Features

Crediting Methodology–popular examples include:

- Term End Point-to-Point
- Annual Reset
- Index Averaging

Fees

- Typically, FIAs do not include explicit fees.

Crediting Methodology:

The crediting method is how the fixed index annuity calculates the interest credited to the policy. There are currently over 40 different crediting methods offered by FIA carriers, and here are descriptions of some of the more popular ones:

•***Term End Point-to-Point –***

Compares the change in the index from a beginning point, such as the beginning of the contract term, to an ending point, such as the end of the term. Point-to-Point may work best when the index it is linked to is increasing, since it can benefit from a lower beginning and higher ending point. Also, a company offering an FIA employing this method may offer a higher IPR or higher Cap due to more efficient pricing of the financial instruments used, which determine IPRs and Caps.

•***Annual Reset –***

Compares the change in the index from the beginning to the end of each year of the FIA's term. Any return is then "locked in" and the beginning index value is reset for the following year. Annual Reset may work best when the linked index experiences volatile *"up and down"* years during a term, since the FIA can take advantage of starting over each year on its anniversary.

•***Index Averaging -***

Index Averaging, (or simply Averaging), averages the index's value on a daily, weekly or monthly basis, rather than using the actual value of the index on a specified date. Index Averaging can help even out volatility and dramatic declines in the index-linked interest, or it may reduce the amount of the interest credited to the FIA because it also evens out increases.

Fees

Typically, FIAs do not include explicit fees. Surrender charges may be imposed if withdrawals are taken before the term ends, if they are in excess of free amounts, or if the contract is surrendered completely. Typical surrender charges range from 1% to 10%, and generally decline over time. Some FIAs, not all, charge an asset fee, often called a *margin or yield spread.* If the FIA does include one of these features, it is normally expressed as a percentage, and this percentage is subtracted from any gain in the index linked to the FIA. For example, if the index gained 15% and the yield spread was 6%, then the interest credited to the FIA would be 9%. *Example:* Index gain minus yield spread equals FIA credited interest, or (15% - 6% = 9%). This can be particularly detrimental to returns if the index gains are low. For example, if the index gained 6% and the yield spread was 6%, then the interest credited to the FIA would be 0%.

Guarantees are backed by the claims-paying ability of the issuing company.

Fixed Index Annuities

Benefits and Disadvantages of FIAs

- Guaranteed principal, if held to maturity
- Guaranteed minimum interest rate
- Growth potential linked to a market index
- Same basic annuity advantages: tax-deferred growth potential, death benefit, avoids probate, choice of income options

Guarantees are backed by the claims-paying ability of the issuing company.

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So what are some of the benefits, as well as some of the disadvantages, of Fixed Index Annuities? We already went over some of them:

FIA benefits include:

• Guaranteed principal Again–most FIAs guarantee the principal from loss, if it is held until the end of its term.

• Guaranteed minimum interest rate–Should the index that it is linked to decrease, the guaranteed minimum interest rate would kick in, as long as the FIA is held throughout the end of its term.

• Growth potential tied to the performance of a stated index, without market risk–Potential to earn better returns than many traditional fixed annuities. This is because it is linked to the potential increases of a market index. A hypothetical illustration of this potential–if an FIA has an Index Participation Rate of , say in this example, 60%, and in this case has no Maximum Credited Interest Rate or Cap, it has the potential to earn 60% of an index that may increase by as much as 20% or higher–representing a 12% or higher return (60% IPR of 20% index increase equals 12%).

Additional FIA benefits, similar to most other annuities, include:

• Tax-deferred growth potential to help money grow more quickly.

• Guaranteed death benefits help ensure a beneficiary's financial security.

• Avoids the time, cost and publicity of probate.

• Many insurance companies offer a number of different choices of distribution payment options, including guaranteed lifetime income options.

Fixed Index Annuities

Benefits and Disadvantages of FIAs

DISADVANTAGES:

- May not receive the index-linked interest on withdrawals taken before FIA term ends, and in some cases may not receive a return of principal.
- Does not receive the TOTAL increase of the market index.
- Same basic annuity disadvantages–withdrawal charges; possible 10% federal tax penalty for withdrawals taken prior to age 59½.

Guarantees are backed by the claims-paying ability of the issuing company.

FIA disadvantages include:

• Most often, if any withdrawals are taken or if the FIA is surrendered before the end of its term, the policyholder may not receive the index-linked interest. Additionally, if it is surrendered before the end of its term, the policyholder could potentially not get back all their principal either, especially in the beginning years of a policy.

• Interest the account earns is only a percentage of index gains, and not the total gain. The reason for this is that the issuing company is assuming all the market risk, and provides protection of principal and the guaranteed minimum interest rate for the policyholder.

Additional FIA disadvantages, similar to most other annuities, include:

• Potentially high fees for withdrawing money before the end of the term, or in some cases that exceeds a specified annual limit.

• Withdrawals prior to age 59½ may be subject to a 10% federal tax penalty.

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Fixed Index Annuities

Benefits and Disadvantages of FIAs

Fixed index annuities are designed for clients who wish to participate in the growth of equity markets but are concerned about the potential of losing their money. An FIA is suitable for those who:

- Are risk averse
- Prefer traditional and conservative methods of saving
- Wish to build and protect their nest egg
- Are changing jobs, retiring, or inheriting money
- Want portfolio diversification
- Desire principal protection, if held to maturity, with upside potential

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Who would an FIA be suitable for? Fixed index annuities are designed for clients who wish to participate in the growth of equity markets, but are concerned about the potential of losing their principal due to market losses.

Clients that a fixed index annuity would be very suitable for include those who:

• Are risk averse and cannot tolerate any market losses or market risk.

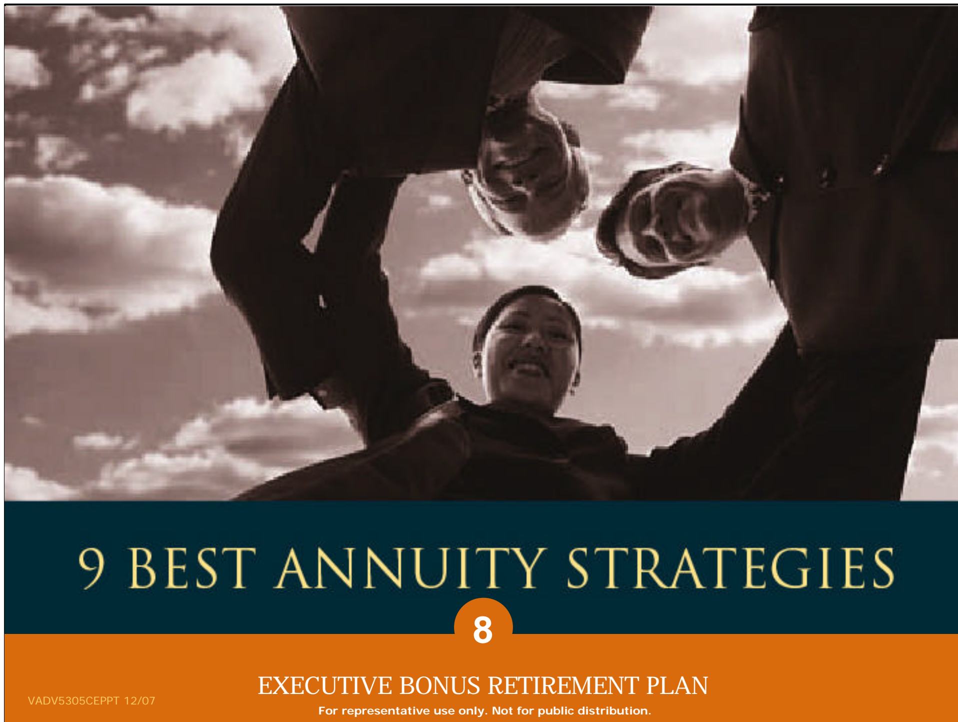
• Prefer to save their money in traditional and conservative methods of saving, including traditional fixed annuities.

• Those who may have lost money during the previous bear market, and are trying to build up their retirement nest egg while at the same time wishing to protect what is left so they won't lose any more. These clients may be relatively close to retirement, and cannot afford to risk their money, but they also can't afford for their money not to continue working for them.

• Many people are more frequently changing jobs, retiring or inheriting money–particularly from a relative's retirement plan, and they want a safe place to put this money for their retirement. A rollover IRA funded with an FIA may be very appropriate for them, especially for those closest to retirement, who are in a position where they cannot afford to risk their principal, if held to maturity.

• Some people may be heavily invested in bonds or some other financial vehicle, and may want to diversify their portfolios so that they would not be as impacted by any one event, for instance, interest rate increases.

• And finally, fixed index annuities are basically suitable for anybody who desires principal protection, if held to maturity, with upside potential, who wants a safe long-term savings solution (especially for retirement), someone who does not have an immediate need for the money they put into it–since an FIA is most effective when left in place until the end of the withdrawal charge period.



The eighth discussion point we will be exploring today is the executive bonus retirement plan.

Executive Bonus Retirement Plan

HOW ANNUITIES CAN BE UTILIZED

The goal is to provide a retirement program on a discriminatory basis for certain employees. It is used as an alternative to an outright bonus.

Annuities may provide a value because of their tax deferral and flexibility, thus providing a clear benefit for both the business owner and employee.

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The goal of this **plan** is to create a retirement program on a discriminatory basis for some employees. The money is not qualified, so the tax deferral provided by an annuity is clearly valuable.

Executive Bonus Retirement Plan

PLAN DESIGN

- Business owner decides participants. No requirements on business owner as to who may or may not participate
- Business owner (and participant) selects the annuity contract
- Business owner makes premium contributions, on behalf of the employee, directly to the insurance company

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Plan Design

• The business owner determines participants. There are no requirements as to who may or may not be included.

• The owner, with assistance of plan participants, selects an annuity contract.

• The owner makes premium contributions on behalf of employee, directly to the insurance company.

Executive Bonus Retirement Plan

PLAN DESIGN (continued)

- Business owner may vary contributions at his/her discretion
- The employee is the Owner/Annuitant on the contract
- If a variable annuity, the employee selects the investment options that meet his or her objectives

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Plan Design

• The owner may vary contributions by participant and may vary contributions as necessary.

• The annuity is owned by the participant, the participant is the annuitant and the participant designates the beneficiary.

• If a variable annuity, the participant selects investment options in line with their individual time horizon and investment objectives.

Executive Bonus Retirement Plan

TAX ISSUES

- Business owner gets deduction
- Employee includes contributions as taxable income
- Business owner may increase employee's salary to practically cover taxes
- Employee receives tax deferral on any potential growth of the annuity

Source: IRC Section 162

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Tax Ramifications

• The owner may deduct the premium contribution (IRC Section 162) provided it qualifies as reasonable compensation to the employee.

• The participant must include the contribution amount as taxable income. [EMPHASIZE.]

• The owner may increase the participant's bonus to cover taxes on plan contributions.

• The participant taxed on growth in the annuity contract only when he/she decides to access the contract.

Executive Bonus Retirement Plan

BENEFITS:

- No IRS red tape
- Completely discriminatory—rewards only those employees that the owner selects
- Business owner receives tax deduction, just as with a qualified plan
- Unlike ordinary bonuses, employee will be less likely to access prior to retirement
- Business owner gains loyalty and lowers turnover

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Plan Benefits

• No ERISA requirements

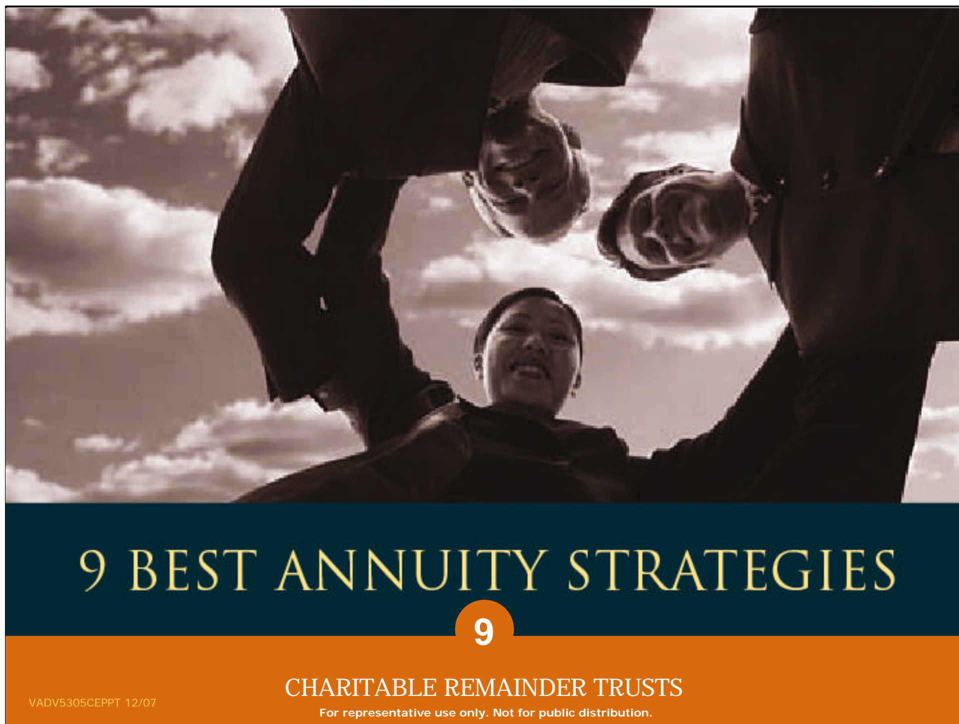
• The plan is completely discriminatory. It rewards only those employees that the owner selects.

• The owner gets tax deduction, just as with qualified plan.

• Because the annuity contract is funding the plan, participants are less likely to access funds prior to retirement, due to withdrawal charges, 10% penalty tax and income tax on earnings.

• The owner gains additional loyalty and lowers turnover of participants.

Of course, the fourth benefit I've listed could also be considered a drawback for participants. In most plans, they are discouraged from early withdrawals because of **the tax implications** and the potential 10% federal penalty on early withdrawals. Using an annuity adds potential withdrawal charges to such withdrawals, as well.



CRT Overview:

- A CRT (Charitable Remainder Trust) is an irrevocable, split-interest trust that provides income to the grantor, generally for life, and passes the remainder to a charity, generally upon the death of the grantor. Taxation is complicated and **you** should always include a qualified tax professional when seriously considering **this** strategy.
- Tax ramifications:
  - There is an income tax deduction for contributions. The size of the deduction is based upon the age of the grantor and level of income retained by the grantor.
  - A CRT removes asset and future growth from the estate of the grantor.
  - Asset(s) contributed to the trust may be replaced for the grantor's heirs through the purchase of life insurance owned by an Irrevocable Life Insurance Trust (ILIT), which keeps insurance out of the estate of the grantor.

It's interesting to note that, since a CRT is considered a non-natural person, the tax deferral of the annuity is not applicable. Tax status becomes that of the non-profit, which is tax exempt.

One of the main reasons for the use of an annuity as a funding vehicle for CRTs is the greater control over distributed income. Many states have adopted trust language that defines distributable net income which makes it conducive for the use of annuities as CRT funding vehicles. This has made the annuity one of the most popular funding vehicles for CRTs on the market today. The product's investment diversification, guarantees and death benefits (as we have discussed earlier) also add to its appeal.

Charitable Remainder Trusts

A DEFINITION

- Must pay income to at least one taxable income beneficiary
- Income is based on a percentage not less than 5% and not more than 50%
- Paid at least annually
- For a life or lives, or a fixed term not to exceed 20 years
- At termination, assets remaining are paid to charity

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CRTs

Must pay income to at least one taxable income beneficiary

• Income is based on a percentage not less than 5% and not more than 50%, determined in the trust document, and cannot be changed **once** the **first** distribution commences

• Paid at least annually

• For a life or lives, or a fixed term not to exceed 20 years

• At termination, assets remaining are paid to charity

Charitable Remainder Trusts

- $41 trillion will pass from parents to their children by 2052.*
- The estimate for charitable giving in 2003 is 2.2 percent of gross domestic product.*
- Americans gave almost $300 billion to charity in 2006.*

*Source: The Giving U.S.A. Foundation press release, 2006

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Charitable Remainder Trusts

NIMCRUT VARIATION

Net Income with Makeup Charitable Remainder Unitrust (NIMCRUT) is a variation where income is paid based on a fixed percentage of annual value or annual income (whichever is less) and "makes up" any past income deficiencies in future years when the trust earns more than required.

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NIMCRUT (Net Income with Make Up Charitable Remainder Unitrust) is a variation of the standard Charitable Remainder Trust. NIMCRUT Variation.

NIMCRUT Varation:

• Assets in trust are typically invested in a variable annuity and in many client situations, only growth options are selected.

• During this accumulation period, no income is distributed to the grantor, using the definition of income contained in the trust.

• Upon the grantor's retirement, or at such time as he or she decides to receive income from the NIMCRUT, the gain in the variable annuity is withdrawn from the contract. This will create "distributable net income" from the trust.

• When this occurs, the trust begins distributing income to the grantor. However, NIMCRUTs have one special feature: A NIMCRUT contains a "make-up" provision, meaning that the trust will make it up to the grantor for all the years of income that were not distributed.

Results?

• The grantor receives an income tax deduction for a portion of the contribution(s).

• The grantor established a supplemental retirement fund that pays out when the Grantor actually needs the funds. Thus, during the accumulation phase, income that would normally be paid out in a traditional CRT is stockpiled in NIMCRUT to await distribution at the grantor's retirement.

• The charity receives the remainder of the trust assets at the grantor's death; NIMCRUT assets are excluded from the grantor's estate.

Charitable Remainder Trusts

ANNUITIES AND CRTs

- Annuities allow you to easily turn on and off income from a Net Income Unitrust without converting investments (which can result in loss of principal).
- Annuities allow access to income greater than current earnings to "make up" income payments from previous years.
- Death benefits and the availability of guaranteed products and options provide added protection.

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48

One of the main reasons for the use of an annuity as a funding vehicle for CRTs is the greater income control by the trustee. Many states have adopted trust language that defines distributable net income, which make it conducive for the use of annuities as CRT funding vehicles. Lets see how this works:

• If income is generated by other popular investments, such as mutual funds, stocks or bonds and this income is paid to the trust, the trustee must distribute it to the income beneficiary. Using an annuity, the trustee, given any number of reasons, can turn the income off or on, and can regulate the amount it receives, regulating the payout to the income beneficiary.

• A spigot is often used as an analogy for this control, whereby the trustee can access undistributed net income, which can be greater than current earnings, to "make up" income payments from previous years. The other investments will simply pay its annual return, and the trustee would be forced to distribute it. Given our poor markets in the past few years, this issue may be moot, but given a rebounding economy and markets, it may become an issue if the client wants to turn the income off for any reason.

• Death benefits and the availability of guaranteed products and options provide added protection.

It is these reasons that have made the annuity a popular funding vehicle for CRTs today.

Charitable Remainder Trusts

BENEFITS

- Avoid capital gains taxes
- Generate higher income from investments
- Create current tax deductions
- Reduce or eliminate estate taxes
- Efficient wealth transfer to heirs

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Tax benefits of CRTs:

• Capital gains taxes are avoided on the sale of the asset gifted to the trust.

• CRTs can help generate higher income from investments and diversification.

• Create current income tax deductions, though, if the assets donated are substantial, donors may not be able to take the full amount of the deduction in the current year, but can carry forward any unused deduction for up to five tax years.

CRT benefits for an estate include:

• Reduce or eliminate estate taxes, though this benefit would be subject to change if changes are made to current estate tax law.

• Efficient wealth transfer to heirs when a CRT, together with an Irrevocable Life Insurance Trust. This may be the option of choice when a client wants to provide benefit to a charity and provide assets to their heirs upon death.

Charitable Remainder Trusts

LIMITATIONS

- Possible loss of inheritance for heirs
- Attorney cost for drafting document
- Ongoing administration costs

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Charitable Remainder Trusts can get very technical. The CRT is irrevocable under federal regulations.

• The gifted asset that is donated to the trust will not go to the donor's heirs in most cases. Usually this is offset through a Wealth Replacement Trust. If replacement insurance cannot be purchased due to cost or insurability, the donor's heirs could possibly have their inheritance reduced to the extent of the donation amount into the CRT.

• Because the trust is so complicated, it is important that a skilled and competent estate-planning attorney draft the documents. The cost of drafting such documents will vary. The prices will range greatly depending on the attorney, the customization of the trust, the amount of the donation to the trust and what part of the country your client lives in.

• There is a need for ongoing administration of these trusts. These fees are usually paid for ongoing monitoring and support of the underlying investment and distributions, as well as ongoing tax reporting. Again, these fees will vary.

We would suggest you and you clients work with a qualified advisor who can counsel on specific individual situations.

As required by the IRS, you are advised that any discussion of tax issues in this material is not intended or written to be used, and cannot be used, (a) to avoid penalties imposed under the Internal Revenue Code or (b) to promote, market or recommend to another party any transaction or matter addressed herein.

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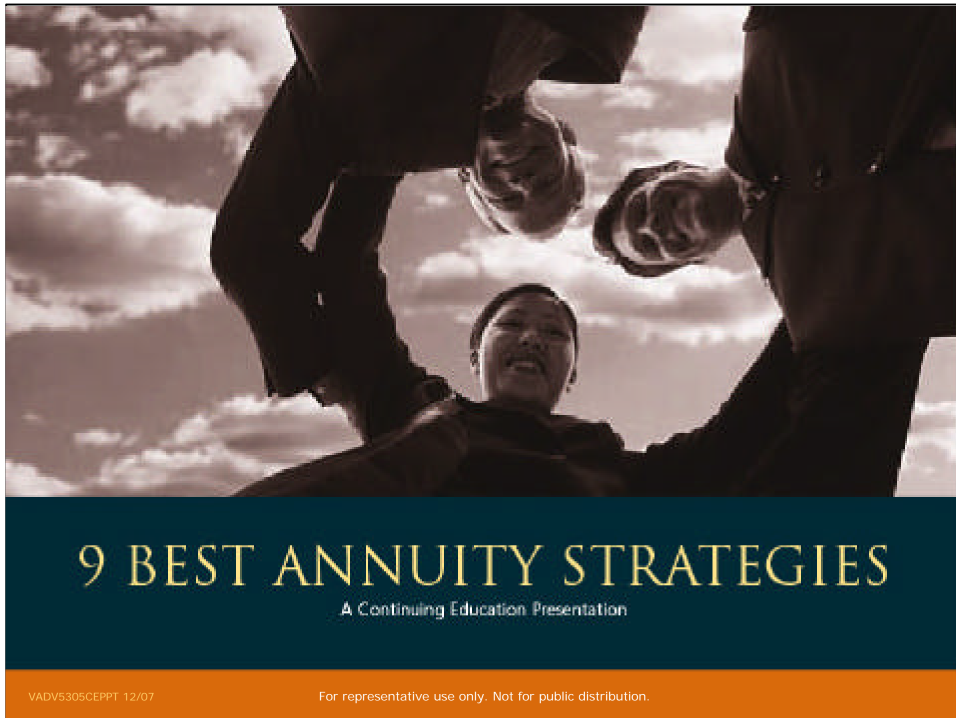

Thank you!
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