

# from Chuck's Desk

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**Chuck Donovan**

## **Annuities**

A number of people asked me to review their annuity contracts last year.



All had difficulty understanding annuities and annuity contracts. The contracts were very difficult, confusing, and hard to read and comprehend. All were insurance company financial contracts offering tax deferred savings arrangements designed as a source of retirement income.

They were: **Fixed Annuities** – those with an immediate payout and fixed investments and **Variable Annuities** – those with a deferred payout and variable investments. Most were variable annuity contracts.

Although my reviews were after the fact, there were a number of things I noticed during them. As a result I feel a discussion of annuities would be of interest and help to you.

### **Very Profitable**

Annuity contracts, particularly variable annuity ones, are extremely profitable for insurance companies and very popular among sales people. It is a big payday for sales people. The broker commission on a variable annuity ranges between 10 to 15% of the contract with the salesperson receiving between 50 to 75% of it. As a result sales people push annuities.

### **Characteristics**

All annuity contracts have two main characteristics: the payout type is either immediate or deferred and the investment type is either fixed or variable.

An annuity with an immediate payout begins payments immediately, while one with a deferred payout begins the payments in the future. The fixed investment type offers a guaranteed return through investments in government bonds and other low-risk securities; while a variable investment one means that the annuity's investment return depends on performance of the funds in which the money is invested.

Most contain the right to examine the contract and cancel it if dissatisfied. There is a ten to thirty day period after the contract has been received to do so. The payment is refunded but adjusted to reflect any investment changes during the period. ***None of the people were aware of this right.***

### **Fixed Annuity**

A fixed annuity is simple. Money is given to an insurance company which promises to pay back a set monthly, quarterly, or annual amount for a fixed period of time or for a lifetime.

### **Variable Annuity**

A variable annuity is basically mutual funds wrapped in an insurance policy. The insurance policy provides tax deferral opportunities and the combination of the insurance and investments provide (1) the tax deferral on investment earnings, (2) a death benefit, and (3) the ability to receive periodic payments for a lifetime. It is designed as a long-term investment to take care of retirement and other long-range goals.



**Affordable Business Services, a full service accounting firm,** offers innovative business solutions to small and medium size companies through specializing in the training, and consulting in the use of QuickBooks business management software.

**Chuck Donovan MBA** brings over 20 years of financial expertise to the business having worked as a senior financial executive with firms ranging in size from \$20 million to \$3 billion in sales.

His broad, hands-on accounting and finance experience has taught him that financial information must be more than just a series of numbers.

He shows and helps business owners to use their financial information to increase their cash flows, improve their profits, and build their companies, so they can plan for a secure future.

**A QuickBooks Professional Advisor and experienced problem solver, Chuck is a graduate of Dartmouth College and received his MBA from American International College.**

A variable annuity contract has two stages: the contract term and a payout period (the time between the end of the contract term and the contract's maturity date). The contract term is as a rule six to eight years, but could be up to ten years. ***I reviewed one with a contract term of sixteen years.***

It offers a range of investment options usually mutual funds investing in stocks, bonds, or money market instruments. Due to the poor performance of the stock markets the past three years indexed funds are now the rage. They guarantee a positive return during good stock market years but no losses during bad years. However, the amount of annual positive return is subject to a cap which is reduced by various rates and fees. The mathematical computation of which is complicated.

It has a sales load, usually very high expenses, and always a charge for mortality insurance. The mortality and expense risk charge is typically 1.25% per year and compensates the insurance company for insurance risks assumed under the contract. In addition, there are annual maintenance fees and administration charges.

### Surrender Charge

The downside is that it is difficult to get at the money. If funds are withdrawn before the end of the contract term, the insurance company applies a "surrender charge", a sales charge used to pay the salesperson a commission for selling the annuity. The surrender charge, stated as an annual percentage, is the penalty for canceling or reducing the contract before the contract term ends. The surrender charge may also be called "a deferred sales charge".



The annual percentage, typically starting at 5 to 10%, declines and disappears at the end of the contract term. For example, on a five year contract a 5% charge may apply in the first year, 4% in the second year, and so on until the last year, when it is zero. ***The sixteen year contract started with a 17.5% surrender charge!***

Most contracts have an option to withdraw 10% of the contract's value each year without suffering the penalty. It is the only way to get out of the contract without a surrender charge but ***will take ten years to do so.*** Surrender charges do apply on any annual withdrawals over the 10%.

### Conclusion

The web site ***annuityzone.com*** lists interest rates, withdrawal penalties, and contract provisions for annuities issued by a number of companies. When thinking about an annuity contract, you should

1. Deal only with AAA and AA rated firms, ones whose names you recognize (for example, Prudential, Hartford) because the insurance company's financial strength, credit standing, and ability to pay future benefits are critical.
2. Enter into an annuity whose contract term is not too long.
3. Be able to elect at the end of the contract term to receive a lump sum payment or a stream of payments at regular intervals.
4. Have the right to examine the contract and cancel it if dissatisfied.
5. Be very certain you will not need the money before the end of the contract term to avoid paying surrender charges.
6. Be aware of the surrender charges, the contract term, payout arrangements, and investment funds of the contract.
7. Understand fully the features of the annuity and all of its fees and expenses.
8. Be aware of any extra features, such as long-term care insurance, that can be purchased less expensively as a separate policy.



Sales people who sell annuities have a duty to advise you whether the annuity they are selling is suitable to your needs. You should not be afraid to ask questions and write down the answers, so there will not be any confusion later as to what was said and done. After all it is potentially a big payday for them and they are anxious to sell you one.

## Ask the Taxman

### Question:

**I expect to get a refund for year 2002. How long do I have before I must file a tax return to get the refund?**

### Answer:

We all know that the IRS pursues someone who owes money relentlessly and forever. It doesn't work the same way when the IRS owes you money.

You have only three years from the date a tax return must be filed to send in your return to claim the refund. For example, the filing date for year 2002 is April 15, 2003. Thirty six months from that date is April 15, 2006. If you file your year 2002 return after the April 2006 date, you can forget the refund.

### Question:

**I am over 65 and have limited income. My friends have told me, if the total of my standard deductions and personal exemption is higher than my income, I do not have to file a tax return. Is that correct?**



### Answer:

The pragmatic and inexpensive response is you would not have to file a tax return if the sum of your standard deductions and personal exemption exceed your income. However, you need to be aware that facts and circumstances do change. Your income may be less than your allowable deductions last year, but this could change in 2003 or later years. If that happens, you need to file a return for the respective year. Therefore, your situation has to be reviewed each year.

Also you need to be aware that, should you make a filing after not having done so for a couple of years, you can expect to receive a friendly "welcome back, we missed you" letter from the IRS requesting an explanation and tax returns for the missing years. Filing every year avoids this trauma.

Moreover, if you are 65 or older with income not over \$21,259, you may qualify for an additional Senior Homestead Exemption. If so, you will need to submit a copy of your tax return to substantiate your request for the additional exemption.

### Question:

**I am setting up an office for my business in my house. What do I have to do to get a tax deduction for it and, if I do claim it, will I get audited?**

### Answer:

The home office you are setting up must be used solely and on a regular basis for administrative or management activities of your business. As your principal place of business it is a location where you meet with client and customers in the normal course of your business. There should not be any other place where you do so on a regular basis.

It can be in a part of your home or a separate structure not attached to your home. If it is in your home, you can take as a deduction a pro-rata portion of expenses such as utility bills, depreciation, rent, insurance, etc. based on the ratio of the square footage of the office to the total square footage of the entire home. You will need to keep careful records and perhaps even photos of the office location. They will be needed if you are audited.

Whether you are audited depends on how aggressive you are with the deductions. The IRS has records on normally claimed home office deductions and would want to look at yours if the deductions are far beyond the normally claimed ones. However, you cannot assume that a home office deduction will automatically cause an audit. There are too many other factors such as questionable things on other parts of your tax return that would cause the IRS to want to see you.

