

LIFE & DEATH TAXATION OF DEFERRED ANNUITIES

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TAXATION OF DEFERRED ANNUITIES

- Outline
 - Types of annuities
 - Tax treatment of annuities during life
 - Tax treatment of annuities at death
 - Required distributions of annuities at death
 - Unique complications of annuities at death

TYPES OF ANNUITIES

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TAXATION OF DEFERRED ANNUITIES: TYPES OF ANNUITIES

- Ways to differentiate annuities:
 - Deferred vs. Immediate
 - Before/after Annuity Starting Date
 - Fixed vs. Variable
 - Qualified vs. Non-qualified
 - Single-premium vs. Flexible-premium

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TAXATION OF DEFERRED ANNUITIES: TYPES OF ANNUITIES

- Deferred annuities
 - Types of deferred annuities
 - Fixed Annuity (FA)
 - Produces “CD-like” returns
 - Variable Annuity (VA)
 - Invest amongst available sub-accounts
 - Equity-Indexed Annuity (EIA)
 - Hybrid structure

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TAXATION OF DEFERRED ANNUITIES: TYPES OF ANNUITIES

- Parties to the contract
 - Owner
 - Owns the contract and has a right to make decisions about the contract
 - Annuitant
 - Measuring life of the contract
 - Insurance company
 - Beneficiary

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TAX TREATMENT DURING LIFE

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TAXATION OF DEFERRED ANNUITIES: TAX TREATMENT DURING LIFE

- Tax-deferral
 - Only applies if owned by a natural person
 - Exception where ownership is “as an agent for a natural person”
 - Trusts as agent
 - Partnerships
 - Other entities
 - Grandfathering exception for pre-March 1, 1986 contracts
 - IRA annuities are subject to IRA rules

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TAXATION OF DEFERRED ANNUITIES: TAX TREATMENT DURING LIFE

- Distributions from annuities
 - Amounts “not received as an annuity”
 - Withdrawals from post-August 13, 1982 contracts
 - Income first to the extent of gains (LIFO)
 - Withdrawals from pre-August 14, 1982 contracts
 - Principal first to the extent of pre-1982 payments (FIFO)
 - Aggregation anti-abuse rules
 - Loans, pledges, or assignments treated as immediately taxable

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TAXATION OF DEFERRED ANNUITIES: TAX TREATMENT DURING LIFE

- Distributions from annuities
 - Premature withdrawal penalties
 - 10% penalty, but applies *only* to the amount of gain reported in income
 - Exceptions to the penalty include:
 - After age 59 ½
 - Death
 - Disability
 - Substantially equal periodic payments
 - Immediately annuity where payments begin within 1 year of purchase

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TAXATION OF DEFERRED ANNUITIES: TAX TREATMENT DURING LIFE

- Distributions from annuities
 - Taxation of partial withdrawals determined *without* regard to surrender charges
 - \$100,000 cost basis, \$105,000 cash value, \$10,000 surrender charge
 - Partial withdrawal: \$5,000 of ordinary income and subsequent loss recapture
 - Full surrender exception
 - Taxable only to the extent net proceeds exceed cost basis
 - \$100,000 cost basis, \$105,000 cash value, \$10,000 surrender charge
 - Full surrender: \$5,000 loss

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TAXATION OF DEFERRED ANNUITIES: TAX TREATMENT DURING LIFE

- Complete surrenders of annuities
 - Gain reported to the extent of gain
- Deductions for deferred annuity losses
 - Allowed as an ordinary loss
 - Claimed as a miscellaneous itemized deduction subject to the 2% floor
 - Above-the-line ordinary loss claims controversial

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TAX TREATMENT AT DEATH

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TAXATION OF DEFERRED ANNUITIES: TAX TREATMENT AT DEATH

- Contract remains in current form
 - Estate tax valuation based on cash surrender value
 - May include adjustments due to death itself
 - Post-death distributions continue to be treated as amounts not received as an annuity, unless annuitized by beneficiary
- Rules requiring distributions from annuity after death

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TAXATION OF DEFERRED ANNUITIES: TAX TREATMENT AT DEATH

- Post-death distribution requirements
 - Annuity is *required* to begin making distributions upon the death of *any owner*
 - May force distributions while annuitant or remaining owner is alive if (different) owner has died
 - If annuity is owned by a non-natural person, primary annuitant is substituted for owner
 - Time period for required distributions will depend upon beneficiaries and annuity contract

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TAXATION OF DEFERRED ANNUITIES: TAX TREATMENT AT DEATH

- Post-death distribution requirements
 - Default – the 5-year rule
 - Entire contract must be distributed by the 5th *anniversary date* of the owner's date of death
 - Different than retirement account rules!
 - Exceptions to the 5-year rule
 - Distributions may be made over the life expectancy of a *designated beneficiary*
 - Spousal continuation

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TAXATION OF DEFERRED ANNUITIES: TAX TREATMENT AT DEATH

- Post-death distribution requirements
 - Payments over life expectancy
 - *Must* begin within 1 year of the owner's death
 - Requires a designated beneficiary
 - "Any *individual* designated as a beneficiary by the owner of the annuity contract"
 - Annuitization to satisfy life expectancy payments
 - Systematic withdrawals to satisfy life expectancy payments
 - Not allowed by all companies (based on PLR)
 - Payments must begin within 12 months of the decedent's date of death (non-calendar year; tax shifting possible)
 - Tax treatment allows cost basis to be allocated over the distribution period as an amount received as an annuity

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TAXATION OF DEFERRED ANNUITIES: TAX TREATMENT AT DEATH

- Post-death distribution requirements
 - Spousal continuation
 - Surviving spouse must be the beneficiary
 - Allows for the spouse to continue the contract in his/her own name
 - Contract continues 'normal' deferred annuity treatment in the name of the spouse
 - Upon death of spouse, normal rules apply based upon the death of the owner
 - Impact on living or death benefits of annuity will depend on the terms of the contract

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TAX TREATMENT AT DEATH: *OTHER NOTABLE ISSUES*

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TAXATION OF DEFERRED ANNUITIES: OTHER ISSUES AT DEATH

- Other notable items
 - Income in Respect of a Decedent
 - Annuities are treated as IRD amounts
 - Post-death distributions may provide for an IRD income tax deduction
 - Be cautious of post-death assignments of benefits that trigger IRD recognition
 - Assignments from estate to estate beneficiary or trust to trust beneficiary
 - Must have ability to make non-pro rata and in-kind distributions
 - Be cautious of satisfying pecuniary bequests; cross-application of IRA-based rulings

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TAXATION OF DEFERRED ANNUITIES: OTHER ISSUES AT DEATH

- Other notable items
 - Step-up in basis
 - Applicable only to pre-October 21, 1979 contracts
 - Variable vs. Fixed
 - Beware of exchanging eligible contracts!
 - Post-death 1035 exchanges
 - Appears to be blessed under PLR 201330016
 - Still depends on contract-specific language

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UNIQUE COMPLICATIONS AT DEATH

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TAXATION OF DEFERRED ANNUITIES: UNIQUE COMPLICATIONS AT DEATH

- Trusts as beneficiaries
 - Designated beneficiary status is restricted to “individuals”
 - Trusts are not designated beneficiaries, and must follow the 5-year rule
 - Lack of “look-through” regulations; no on-point guidance
 - Parity with IRC Section 401(a)(9) (and the lack thereof)
 - Spousal continuation
 - PLR guidance for continuation with a Revocable Living Trust (RLT)
 - Potential to make post-death assignment through RLT

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TAXATION OF DEFERRED ANNUITIES: UNIQUE COMPLICATIONS AT DEATH

- Jointly held annuities
 - Payouts to third-party beneficiaries
 - Annuity contract may follow beneficiary designation to the exclusion of surviving owner
 - Inter-vivos gift from surviving owner to beneficiary
 - Potential loss of spousal continuation
 - Annuity contract provisions may “save” by contractually overriding beneficiary designation
 - Non-spousal joint owners
 - No opportunity for contract continuation at 1st death
 - Beware payouts to third-party beneficiaries

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TAXATION OF DEFERRED ANNUITIES: UNIQUE COMPLICATIONS AT DEATH

- Multiple beneficiaries
 - Lack of clarity on how to handle multiple beneficiaries
 - No designated beneficiary determination date
 - Whose life expectancy is used; can contract be split?
 - Consequences of designated and non-designated beneficiaries?

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TAXATION OF DEFERRED ANNUITIES: SUMMARY

- Summary
 - Annuities have a unique tax structure of their own
 - Be aware of both tax treatment and potential for grandfathered tax rules
 - Be certain to have all of the information before you act
 - Consider addressing problem situations before death, if possible (e.g., trusts as beneficiaries, ownership structuring issues, etc.)

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