TAXATION OF NON-QUALIFIED ANNUITY CONTRACTS

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I. Introduction:

A deferred annuity contract is an insurance contract purchased today that will provide annual (or more periodic) payments over the life of an individual or some other fixed period of time beginning at some future date. The primary reason behind the purchase of a deferred annuity is to provide retirement income, even though many individuals may never annuitize or may not actually annuitize their contract until many years after their retirement date. Amounts are paid into an annuity contract either in a lump sum or over a period of time. Earnings within the annuity contract grow on a tax-deferred basis, and can later be converted into a steady stream of income. This favorable tax treatment that defers income tax liability, from the growth phase to the income payment phase, has encouraged the use of an annuity as a retirement savings vehicle.

The advent of the variable annuity presented policyholders with an array of investment choices. This made the annuity contract attractive to anyone who was considering equity investments yet wanted to avoid the current income tax on the earnings it generates. In addition, insurers developed optional riders, for an additional cost, (that offered additional benefits), such as enhanced income riders and enhanced death benefit riders, which provided guarantees that could not be found with other types of equity investments. Many of these riders were designed to help offset the risks associated with funding a variable annuity, including the risk of losing money due to market declines.

As a result, the tax-deferred annuity became a popular tax-favored investment that was often purchased by individuals with little interest in using the annuity to provide retirement income.

During the 1980's, Congress took steps to ensure that annuity contracts would be utilized primarily as retirement savings vehicles and not as a tax-sheltered investment. These changes began with the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") and continued with a series of tax acts in which Congress narrowed the favorable tax treatment of annuity contracts to ensure these products favored those who only purchased the contracts for retirement funding purposes.

This article will examine the different types of nonqualified deferred annuity contracts, which is a contract purchased with after-tax money, and will provide examples of how distributions from annuity contracts are taxed, explain the non-natural person rule, and discuss the gift and estate tax consequences of transferring an annuity contract.

II. Types of Contracts

There are two types of deferred annuity contracts: annuitant-driven contracts and owner-driven contracts. An annuitant-driven contract is often an older contract whose contractual benefits (e.g., enhanced death benefit) are paid upon the death of the annuitant. Individuals often purchased these contracts and named as the annuitant someone that was significantly younger in order to defer any tax for as long as possible. Congress eliminated this potentially abusive practice by enacting a new code section that mandated the termination of an annuity contract upon the death of the holder (owner) of the contract.[1] This new provision of the Code applies to contracts issued after January 18, 1985.

An owner-driven contract is a contract in which the contractual benefits are paid upon the death of the owner. These contracts were developed so that the contractual provisions were consistent with the requirements of the Internal Revenue Code mandating that a contract terminate upon the death of the holder/owner. The majority of the annuity contracts being sold by insurance companies today fall into the category of owner-driven contracts.

Suggested Ownership Arrangements:

The proper titling of an annuity contract is important to ensure that the proceeds are paid in accordance with the expectations of the owner. Generally, the owner and the annuitant should be the same individual. This is true whether the contract is owner-driven or annuitant-driven and assures the payment of the policy's contractual benefits upon the death of the owner.

Many times a couple will purchase an annuity contract and automatically name both spouses as the owners of the contract. There is often little benefit to be derived by having an annuity contract jointly owned. In fact, creating joint ownership may create misplaced expectations on the part of the owners. Most couples incorrectly assume that a jointly owned contract includes a right of survivorship. Unfortunately, this mistaken

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[1] IRC §72(s).

perception does not come to light until after the death of one of the owners when the proceeds are paid to the designated beneficiary.

The contract proceeds will be paid to the designated beneficiary unless the contract contains a provision that provides that a surviving joint owner will contractually be designated the primary beneficiary thereby overriding any beneficiary election made by the owners. Therefore, the safest way to ensure that the proceeds are paid to the surviving owner is to designate the owners as the beneficiaries of the contract. (Later in this article we will look at an option that is only available when the designated beneficiary is the surviving spouse of the holder of the contract.)

III. Lifetime Distributions

Withdrawals

Distributions from an annuity contract purchased after August 13, 1982, are taxable as ordinary income to the extent the accumulated values exceeds the investment or basis of the contract.[2] It is important to remember that all taxable distributions, even those from a variable annuity contract, will be taxed as ordinary income, and do not qualify for the reduced tax rates that apply to long-term capital gains and dividends.

> Example: Peter, age 53, purchases a variable annuity contract with an initial payment of $60,000. Four years later, the contract has an accumulated value of $75,000 and a surrender value of $67,000. Peter withdraws $12,000 as a down payment on a car. Since the accumulated value ($75,000) exceeds the investment in the contract ($60,000) by $15,000, the entire $12,000 is taxed as ordinary income. Note that the $8,000 surrender charge is ignored for purposes of determining how much of the withdrawal is taxable.[3] (The possible application of the premature distribution tax will be discussed later in this article.) If Peter had surrendered the contact in the above example, then he would only have recognized $7,000 as income, which is the difference between the investment in the contract ($60,000) and the surrender value ($67,000).

If the contract's accumulated value at the time of the distribution is less than the investment or basis in the contract, then the distribution will not be taxable nor will there be a loss generated by the withdrawal. A loss is not realized until the contract is surrendered or the benefit payments have terminated. If there is a loss after the contract has either been surrendered or the benefits have terminated, then the loss may be deductible.

> Example: Marissa purchases an annuity contract in 1999 with an initial payment of $150,000. The current accumulated value of the contract is $145,000 and the surrender value is $140,000. Marissa will have an ordinary loss of $10,000 if she surrenders the contract.

There is no clear-cut authority as to where the loss should be reported on the taxpayer's federal income tax return. The most aggressive position would be to place the loss on

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[2] IRC §72(e).
[3] IRC §72(e)(3).

Form 1040, or the loss could appear on Schedule A, not subject to the 2% floor, of Form 1040. Finally, the least aggressive position would be to take the loss on Schedule A subject to the 2% floor. Because of the uncertainty surrounding where on the tax return the loss should appear, the client should first discuss this issue with a competent tax advisor before taking a deduction for the loss. The Service in IRS Publications has taken an inconsistent position on this issue. On page 11 of IRS Publication 529 (2005), it states that the loss deduction is not subject to the 2% limit and refers the reader to Publication 575 (2005). This publication provides on page 20 that the loss is a miscellaneous deduction subject to the 2% floor.

Pledging and/or Loans

Pledging an annuity contract as collateral or taking a loan from an annuity contract will be considered a distribution and will be taxed the same as a withdrawal. Since a loan or a pledge of a policy is treated as a withdrawal, the taxable portion of the distribution is determined by looking at the accumulated value, and not the surrender value, of the contract.

> Example: Peter owns a contract with a basis of $60,000, an accumulated value of $75,000 and a surrender value of $67,000. He pledges a portion of the contract ($20,000) as collateral for a loan. Peter is considered to have received a distribution of $20,000 and will have taxable income of $15,000 and the remaining $5,000 represents a return of basis.[4]

Multiple Contracts

The change in the distribution rules from FIFO (first in first out) to LIFO (last in first out) in 1982 led some individuals to seek ways to access annuity contract values on a more tax favored basis. One way to accomplish this was through the purchase of multiple contracts. By purchasing two or more contracts, a contract owner could access basis sooner than if only one contract had been purchased.

> Example: Mr. Jones purchased an annuity contract from Company A with an initial payment of $50,000 and the contract has an accumulated value of $90,000 (no surrender charges). Mr. Jones would have to withdraw $40,000 of taxable income before he would receive any portion of his basis. If Mr. Jones had purchased two contracts, each contract would have been worth $45,000 and would have a basis of $25,000. Therefore, Mr. Jones would be able to access the basis of Contract 1 after withdrawing only $20,000 of gain.

The potential for abuse was recognized and legislation was enacted which requires all annuity contracts purchased by the same policyholder, from the same insurer (including the insurer's distribution partners) during any calendar year to be aggregated and treated as one contract.[5] This rule prevents Mr. Jones in the preceding example from accessing basis until the gain from both contracts has first been withdrawn. It is important to note that the aggregation rule does not apply to immediate annuities.[6]

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[4] IRC §72(e)(4)(A).
[5] IRC §72(e)(11).
[6] Conference Report on OBRA 1989.

While the aggregation rule has reduced the potential abuse through the purchase of multiple contracts, there may be ways around the aggregation rules. The rule applies to the purchase of multiple contracts by the same policyholder, from the same insurer during the calendar year. Therefore, it may be possible to avoid the aggregation rules by purchasing contracts from different insurers or from the same insurer but in different calendar years. A married couple may be able to purchase two contracts from the same insurer by having each spouse own one contract. If you have a client that is trying to avoid the aggregation rule, then the client should first discuss this technique with a CPA or other tax advisor before purchasing multiple policies.The above rules regarding lifetime distributions apply to annuity contracts entered into on or after August 13, 1982 and to additional investments made on or after that date to contracts entered into before that date.[7]

IV. Premature Distributions

Section 72(q)(1) of the Internal Revenue Code imposes an additional 10% penalty tax on the taxable portion of a premature distribution from an annuity contract issued after January 18, 1985. It is important to remember that the penalty tax **only** applies to that part of the distribution that is taxable. Apparently, the penalty tax may not apply to contracts issued after August 13, 1982 and prior to January 18, 1985 provided the distribution is allocable to an investment made in the contract more than 10 years before the date of distribution.[8]

> Example: Bill (age 34) purchased a deferred annuity contract on September 3, 1984 with a $100,000 single payment. Bill takes a $20,000 withdrawal in 2006 when the contract is worth $265,000. The $20,000 withdrawal is income taxable but is not subject to the 10% penalty tax because the contract was purchased before the effective date of the penalty provision and the investment was made more than 10 years before the date of distribution.

Exceptions to the 10% Penalty

Age 59 ½. There are a number of exceptions to the application of the 10% penalty tax: one of the exceptions is for a distribution that occurs after the taxpayer attains the age of 59 ½.

> Example: Peter, age 53, purchases a variable annuity contract with an initial payment of $60,000. Four years later, the contract has an accumulated value of $75,000 and a surrender value of $67,000. Peter withdraws $12,000 as a down payment on a car. Since the accumulated value ($75,000) exceeds the investment in the contract ($60,000) by $15,000, the entire $12,000 is taxed as

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[7] PL 97-248 ("TEFRA"), §265(a). According to the IRS, withdrawals from a pre-8/14/82 contract containing investments made both before and after that date will be considered to come first from the pre-8/14/82 investments, then from income associated with those investments, then from income associated with a post-8/13/82 income and finally the post-8/13/82 investment. See Revenue Ruling 85-159, 1985-2 CB 29.

[8] PL 98-369, §222(a).

ordinary income. The taxable amount of the withdrawal ($12,000) is also subject to the 10% penalty tax resulting in an additional $1,200 of taxes.

What happens if a policy is jointly owned and one of the owners is over age 59 ½ and the other owner is under the age of 59 ½? Will the exception apply or will the penalty be imposed? The answer to this question is unclear since the Service has not addressed this issue. Therefore, it would be prudent for a client to address this issue with their tax advisor before taking a taxable distribution from the contract.

Will the exception to the 10% penalty tax apply when an annuity contract is owned by an irrevocable trust? This is another issue that has yet to be addressed by the Service. It appears likely that the 10% penalty will apply to any taxable distribution unless one of the other exceptions applies.

Death of Owner. Any payment received upon the death of a holder (owner) is an exception to the 10% penalty tax. When an annuity contract is owned by a non-natural person, the exception for the death of an owner applies upon the death of the primary annuitant. Unintended tax consequences may be incurred when the owner and annuitant of an annuitant-driven annuity contract are not the same.

> Example: Bill, age 48, owns an annuity contract (annuitant-driven) and names his father as the annuitant and names himself as the beneficiary. If Bill dies, the annuity proceeds would be paid out to the beneficiary and the 10% penalty would not apply because it is being paid as a result of the death of the owner. But if Bill's father dies, an annuitant- driven contract would terminate and the 10% penalty tax would apply because payment is not being made on account of the death of the owner. Therefore, the distribution does not fall within this exception.

This unusual result would not occur with an owner-driven contract because these types of contracts terminate upon the death of the owner, and not the death of the annuitant, so the exception would apply.

Disability. Payments attributable to a taxpayer becoming disabled will not be subject to the penalty tax even if the taxpayer is under age 59 ½. However, this exception only applies if the taxpayer is unable to engage in any gainful activity resulting from a medically determinable physical or mental impairment which can be expected to result in death or last for an indefinite duration.[9] The requirements for this exception are similar to the Social Security definition of disabled, which means it will be difficult for a client to qualify for this exception.

*Immediate Annuity.*Payments made under an immediate annuity contract are not subject to the premature distribution penalty tax. An immediate annuity is defined as a contract that is purchased with a single premium or annuity consideration and annuity payments commence no later than one year from the purchase date of the contract.[10] A section 1035 exchange of a deferred annuity contract for an immediate annuity contract will not avoid the imposition of the 10% penalty tax. The holding period of the original contract (the deferred annuity) will be added or "tacked on" to the holding period of the

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[9] IRC §72(q)(2)(C) and §72(m)(7).
[10] IRC §72(u)(4).

exchanged for contract which makes it extremely unlikely that the new contract will satisfy the Code's definition of an immediate annuity. This prevents the avoidance of the penalty tax by the simple exchange of annuity contracts.

*Substantially Equal Periodic Payments (SEPP).*A payment that is part of a series of substantially equal periodic payments made for the life or life expectancy of the taxpayer or the joint life or the joint life expectancy of the taxpayer and his designated beneficiary is an exception to the 10% penalty. The IRS has indicated that there are three methods for calculating a distribution that will satisfy the SEPP requirement.

- <u>Required minimum Distribution Method (RMD):</u> Simply divide the account balance by the life expectancy of the taxpayer using a table provided by the IRS. This is recalculated each year and results in payments that will differ from year to year because the account balance will fluctuate from year to year.

- <u>Amortization Method:</u> The account balance is amortized over a period of years based upon the owner's life expectancy and using a reasonable interest rate determined on the date distributions commence. This rate is published by the IRS monthly and will often fluctuate from month to month. This method produces a level distribution amount each year.

- <u>Annuity Method:</u> This method divides the account balance by an annuity factor that is derived by using an appropriate mortality table (note: the contract is not annuitized). This will produce a level distribution amount each year.

The three methods described above will result in differing amounts satisfying the requirement for a SEPP. Generally, the largest payment will be derived using either the annuity method or the amortization method so these are often the favored choices. The owner cannot choose a specific dollar amount, nor can the owner choose to receive more or less than amount determined under the applicable calculation method and still satisfy the SEPP requirement.

It is important to remember that payments received under the SEPP exception will result in the distribution of income first and principal will not be recovered until after all of the income from the contract has first been distributed. In addition, amounts received under the SEPP exception must continue until the LATER of the owner's age 59 ½ or five (5) years after the date of the first payment. There cannot be any changes to the payment stream, either an increase or decrease, before this time period has elapsed or the 10% penalty will apply retroactively with interest.

> Example: Bill is 52 and has an annuity with an account value of $330,000 and will begin receiving distributions under the annuity method on March 1, 2006. The annuity method has been elected and he will receive payments of $20,994.92 a year without incurring a 10% penalty. This payment stream cannot be changed without penalty until after Bill attains age 59 ½. If Bill had been 56 when the payments had begun, then he could not change the stream of payments without penalty until after five (5) years.

The IRS will allow a one-time change from either the annuity method or amortization method to the RMD method.[11] This change in policy occurred because the account values of many contracts were eroded by the downturn in the stock market and continuing with the method selected would have resulted in the rapid liquidation of the contract. However, making this one-time election when account values have dropped significantly will result in the owner receiving substantially smaller payments and these revised amounts may not meet the owner's income needs. This places the owner in the difficult position of either continuing to receive payments that may result in the early termination of the contract or accepting less money than is needed in order to continue the contract.

Final regulations effective in 2006 provide that all contract benefits (e.g. enhanced death benefit and guaranteed income rider) must be valued in order to determine the value of a qualified annuity contract for purposes of determining a required minimum distribution (commencing at age 70 ½). While this requirement does not yet apply to nonqualified contracts, one should not be surprised if the Service later determines that the value of a nonqualified annuity contract may be greater than the contract's accumulated value.

V. Ownership by a Non-Natural Person

When an annuity contract is owned by a non-natural person, such as a corporation or partnership, then the annuity contract will lose its tax deferred status and the owner will be taxed as the income is earned and accumulated.[12] There is an exception to this rule when the non-natural person is acting as an agent for a natural person. The income on the contract is determined at the end of each year by using the following formula:

> Taxable income = (Net surrender value + all distributions received) – (Total net premiums + all amounts previously taxed)

The following examples will help illustrate this concept.

> Example: In 2004, the Acme Corporation has purchased an annuity contract on the life of its Vice-President of Sales with an initial payment of $70,000. At the end of the year the contract has a net surrender value of $73,000. Acme must include $3,000 in income (($73,000 + $0) – ($70,000 + $0)) on its income in tax return for 2004.
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> The Company puts another $60,000 into the contract in 2005 and at the end of the year the contract has a net surrender value of $133,000. Acme has no taxable income from the annuity contract in 2005 (($133,000 + $0) – ($130,000 + $3,000)).
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> The Acme Corporation withdraws $10,000 from the contract in 2006. The net surrender value at the end of the year is $134,000 and Acme has $11,000 of ordinary income in 2006 (($134,000 + $10,000) – ($130,000 + $3,000)).

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[11] See Notice 2004-15 and Revenue Ruling 2002-62.
[12] IRC §72(u).

> Finally, in 2007 the Acme Corporation does nothing to the contract and at the end of the year the net surrender value is $141,000. The Company has $7,000 of income in 2007 (($141,000 + $10,000) – ($130,000 + $14,000)).

Agent Exception

The non-natural person rule does not apply when the annuity contract is owned by an entity that is acting as an agent for a natural person. For example, the Service determined that tax deferral was not lost when a corporation owns a group annuity contract for its employees, each of whom has a certificate of participation.[13]

There have been numerous private letter rulings issued by the Service in which an annuity contract owned by an irrevocable trust did not result in the loss of the tax deferral. A recurring pattern in these rulings is the fact that **all** of the beneficiaries of the trust were natural persons.[14] Therefore, it is reasonable to assume that the inclusion of a non-natural person as a beneficiary, such as a charity, may result in the loss of deferral status. In fact, the Service has previously indicated that an annuity contract owned by a charitable remainder trust will be treated as owned by a non-natural person.[15]

Additional Exceptions

The non-natural person rule does not apply to an immediate annuity contract. It will also not apply (i) when the estate becomes the owner as a result of the death of the owner, (ii) if it is a qualified funding asset (used in a structured settlement), (iii) if it is an annuity held under a qualified plan, or (iv) if it is an annuity purchased by an employer upon the termination of a qualified plan and held by the employer until all amounts are distributed to the employee or his beneficiary.

Even though an exception to the non-natural person rules may apply, distributions from the contract will be subject to the 10% penalty tax since a non-natural person does not have a measuring life and, therefore, cannot satisfy the age 59 ½ exception. The non-natural person rules apply to contributions made to annuity contracts after February 28, 1986.

VI. Gift of an Annuity Contract

The gift of an annuity contract issued after April 22, 1987 will result in the donor being taxed on the gain at the time of the transfer.[16] The amount of the gain is the difference between the investment in the contract and the cash surrender value of the contract.[17] This rule is designed to prevent the possible shifting of taxable income to someone in a

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[13] See PLR 200018046.

[14] See PLRs 9204014, 9204010, and 199905015. See also PLR 200018046.

[15] See PLR 9009047.

[16] For a contract issued prior to April 23, 1987, the donor will only recognize the gain that existed at the time of the transfer **if** the donee subsequently surrenders the contract. The gain will be recognized by the donor in the year in which the donee surrenders the contract. The donee will be taxed on the gain in excess of the amount of gain recognized by the donor.

[17] IRC §72(e)(4)(C).

lower tax bracket by subjecting the donor to immediate taxation on the gain in the contract. It is important to note that this rule does not apply to a distribution of an annuity contract from a trust to a trust beneficiary.[18]

Recognition of gain on the gift of an annuity will result in the donee receiving a basis in the contract equal to the donor's basis, increased by the amount of income recognized by the donor at the time of the gift. This eliminates the possibility that the gain in the contract will be taxed twice.

> Example: Donor purchased an annuity contract in 1997 for a single payment of $250,000. The Donor transfers the contract to his daughter in 2006 when the contract has a cash surrender value of $285,000 and an accumulated value of $290,000. The Donor will recognize $35,000 of income in the year of the transfer and will have made a gift with a value of $285,000 to his daughter. The daughter's basis in the contract will be the Donor's basis of $250,000 plus the $35,000 of income recognized or $285,000.

Exception for Transfer to a Spouse or Former Spouse

The tax rules, discussed above, do not apply if the transfer is to a spouse or to a former spouse if the transfer is incident to a divorce.[19] Care must still be exercised even if the transfer will not generate a present tax liability. For example, a transfer of an annuitant-driven contract may result in the contract having a different owner and annuitant. This could create an unexpected tax liability if the annuitant were to die and the owner is under the age of 59 ½. The exception to the 10% penalty for distributions on account of death only applies upon the death of the owner. This result would not occur if an owner-driven contract were transferred since these contracts terminate upon the death of the owner and not the annuitant.

The exception for a transfer to a spouse or former spouse will only apply if the contract itself is transferred. Taking a withdrawal of one-half of the contract's value and giving this amount to a spouse or former spouse pursuant to a divorce decree will be treated as a distribution and may result in taxable income to the annuity owner.

Gift to a Charitable Remainder Trust

An annuity contract with substantial gain is generally not a good choice for funding a charitable remainder trust since the donor will recognize the entire gain at the time of the transfer. The tax benefit of the charitable contribution will be largely, if not entirely, offset by the recognition of income. The gift of an annuity contract to a charitable remainder trust should generally only be considered when the contract has a substantial basis and very little gain.

Transfer to a Revocable Trust

A transfer of an annuity contract to a revocable trust created by the owner of the annuity contract should not be treated as a gift that triggers the recognition of income. There is

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[18] See PLRs 199905015, 9204014 and 9204010
[19] IRC §1041.

no gift and, therefore, there should be no recognition of income upon the transfer of the contract to the revocable trust.

VII. Death of the Holder (Owner)

An annuity contract issued after April 22, 1987 must terminate upon the death of any owner and benefits will then be paid to the designated beneficiary. The death of any owner will trigger the termination of the annuity contract even when the contract is owned by a number of individuals.[20] When a non-natural person owns an annuity contract, then the primary annuitant will be treated as the owner and the contract will terminate upon the death of the annuitant.[21]

When death occurs after the annuity starting date, any remaining amount must be distributed to the designated beneficiary at least as rapidly as the method for receiving distributions prior to death. If death occurs before the annuity starting date, then a beneficiary must receive the entire interest within five years of the date of death of the owner. Satisfying the five-year requirement does not mean that payments must be received in a level amount during this time. This requirement will be satisfied so long as the entire proceeds are received, whether in equal or unequal payments, within the required period.

There is an exception to the five-year requirement if the beneficiary elects to receive distributions stretched over the beneficiary's life expectancy. The life expectancy distribution requirement will only be met if distributions begin not later than one year after the death of the holder and are based on the life or life expectancy of the beneficiary.[22] Receiving an annuity for life will satisfy this exception and the exclusion ratio would be applied to each payment until such time as the entire basis has been recovered. It is not, however, necessary to annuitize in order to qualify for this exception. Systematic distributions based upon the life or the life expectancy of the beneficiary will also qualify for this exception. However, these payments will be treated as distributions and all gain must first be distributed before a distribution of basis will occur.

Spousal Continuation

If the owner's spouse is the designated beneficiary of the annuity contract, then the surviving spouse may make an election to treat the annuity contract as his/her own. This affords the surviving spouse the option of continuing the contract as if it was his/her own contract, thereby continuing the tax deferral possibly until his/her own death, or receiving payments under one of the methods discussed above.

> Example: W is the owner and the annuitant of a contract and has named H as the designated beneficiary. Upon W's death, H may elect to continue the contract and become the owner and the annuitant thereby postponing the tax on the income of the contract. H also has the option of receiving distributions within the five-year period or based on life expectancy. The 10% penalty will not apply,

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[20] IRC §72(s)(1).
[21] IRC §72(s)(6).
[22] IRC §72(s)(2).

regardless of H's age, because the distributions are received on account of the death of the owner.

As previously discussed, joint ownership of an annuity contract, even when the spouse is the co-owner, does not ensure that the surviving spouse may continue the contract. The only way to provide the surviving spouse with the option to continue the contract (and the tax-deferral) is to designate the surviving spouse as the beneficiary. Joint ownership alone will not afford the option of spousal continuation unless the contract by its terms (unlikely) designates the surviving spouse as the beneficiary.

VIII. Tax-Free Exchanges

A life insurance, endowment or an annuity contract may be exchanged tax-free for an annuity contract pursuant to IRC section 1035. The owner must be the same on both the old and the new contract. In addition, the insured/annuitant must also be the same on both the old and the new contract. Caution must be exercised when exchanging a life policy, subject to a loan, for an annuity contract because the loan will be discharged or forgiven which may result in the recognition of income. The amount of the loan that is forgiven will be considered property received in addition to the exchanged for property (the annuity contract). When this occurs, then the additional property received (also referred to as "boot") will be taxable to the extent of the gain in the contract, not to exceed the amount deemed to have been received.[23]

> Example: William owns a life insurance policy with an accumulated value of $110,000, subject to a $20,000 loan, and there are no surrender charges leaving a net cash surrender value (csv) of $90,000. He has a basis in the policy of $80,000 when he decides to exchange the life policy for an annuity contract. The policy has a gain of $30,000 (($90,000 csv + $20,000 loan) - $80,000 basis = $30,000 gain) and the $20,000 loan is forgiven at the time of the exchange. The forgiven loan is considered additional property received as part of the exchange and taxable to extent of the gain, not to exceed the amount of additional property received. Therefore, since the additional property received is valued at $20,000 (the forgiven loan) and the gain at the time of the exchange is $30,000, then William will be considered to have received $20,000 of ordinary income.
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> If the facts remain the same except the amount of the gain is $12,000, then the exchange would result in the recognition of $12,000 of income and the remaining amount ($20,000 (loan) - $12,000 (gain) = $8,000) will be considered a return of basis. The usual life insurance distribution rules do not apply when there is an exchange and property in addition to the exchanged for property is received.

In recent years the Service has issued a number of rulings that have expanded the breadth of section 1035 and created additional planning opportunities for many taxpayers. It is now possible to execute a partial exchange of a contract for another contract as a result of the *Conway* decision.[24] In *Conway*, the taxpayer exchanged a

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[23] IRC §1031(b).
[24] IRC §Conway v. Commissioner, 111 TC 350 (1998), acq. 1999-2 CB xvi.

portion of an existing annuity contract for a new annuity contract. The basis in the new contract was apportioned in a manner that was proportionate to the amount that was rolled over to the new contract. This created a potentially abusive situation since withdrawals from the new contract would enable the owner to access basis sooner than if the original contract had not been split. To combat this potential abuse the Service has indicated that a withdrawal or surrender within 24 months of the exchange will be considered part of one transaction and the contracts will be treated as one contract.[25]

> Example: Mary owns an Annuity Contract A with a cash value of $100,000 (basis of $60,000) and Annuity Contract B with a cash value of $85,000 (basis of $65,000). Mary does a partial exchange of $20,000 from Contract A to Contract B. This will result in 20% of the basis of Contract A ($12,000) being transferred to Contract B. The remaining $8,000 transferred will represent gain. Contract B will end up with a cash value of $105,000 ($85,000 + $20,000) and a basis of $77,000 ($65,000 + $12,000).

For many years the insurance industry took the position, based upon IRS rulings, that a section 1035 exchange could only be made to a new policy or contract. An exchange to an existing policy or contract would not qualify because there was no exchange of one policy or contract for another policy or contract. This all changed when the Service issued a Revenue Ruling[26] in which it allowed the exchange of one annuity contract to an existing annuity contract. The Service determined that permitting this type of exchange is consistent with the legislative intent of allowing taxpayers to exchange a policy or contract for another policy or contract that better suits the taxpayer's needs.

The exchange of a corporate owned life insurance policy for an annuity contract raises some interesting issues that have not yet been addressed by the Service. Will this exchange qualify as a tax-free exchange under section 1035? Remember an annuity contract owned by a non-natural person is not considered an annuity contract for tax purposes.[27] Applying the formula discussed above ((Net surrender value + all distributions received) – (Total net premiums + all amounts previously taxed)) will result in the gain being taxed in the year of the exchange. Therefore, it is likely that an exchange of a life insurance policy for an annuity contract may not provide the corporation with the tax deferral that had been anticipated. The result should be the same whenever an entity exchanges a life policy for an annuity contract unless the entity is acting as an agent for a natural person.

Often times the exchange of an annuity contract for another annuity contract will result in the new contract being subject to any tax law changes that otherwise may not have applied to the original contract. As a general rule, any grandfathering is lost upon the completion of the section 1035 exchange. However, the first in first out (FIFO) rules that apply to distributions from contracts that were issued prior to August 14, 1982 will continue to apply even if the contract was later exchanged for another annuity contract.[28] Contributions after August 13, 1982 will only be recovered after all gain has been distributed from the contract. If a client exchanges one of these contracts, then the client

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[25] Notice 2003-51.
[26] Rev. Rule. 2002-75.
[27] IRC §72(u)(1).
[28] Rev. Rule. 85-159, 1985-2 CB 29.

would be well advised to track their pre-TEFRA contributions and remind the insurer that the amount distributed represents pre-TEFRA contributions. This may help prevent the inadvertent issuance of an incorrect Form 1099-R.

As previously discussed, gain on an annuity contract is taxed as ordinary income and there is no step-up in basis upon the death of the owner. There is an exception to this rule for a variable annuity contract issued prior to October 21, 1979. These contracts may receive a step-up in basis to the policy's fair market value upon the death of the owner. Since this step-up in basis provides a tremendous benefit to the named beneficiary, these favored contracts should not generally be exchanged as the step-up in basis will be lost.[29]

IX. Estate Tax Treatment

When the owner of an annuity dies, the value of that annuity contract will be included in determining the value of the decedent's estate. If the owner dies before the annuity starting date, then the cash surrender value represents the value of the annuity for estate tax purposes. However, the value of the annuity will be determined differently if the contract has been annuitized and there are additional payments required under the annuity option selected by the decedent. In this situation, it is the present value of the remaining payments that will be included in the decedent's estate.[30] (For a discussion of the options available to the beneficiary, please the section entitled "Death of the Holder (Owner)".

The income taxable portion of the annuity benefit is equal to the amount in excess of the owner's basis in the annuity contract. An enhanced death benefit is not considered life insurance proceeds and, therefore, the amount of this benefit will be included in determining the taxable portion of the annuity contract. The taxable amounts received by a beneficiary will be considered income in respect of a decedent or IRD.[31] Income in respect of a decedent represents income that would have been taxable to the decedent had the decedent received the income in the year of death. This income will instead be taxable to the beneficiary when received. Some examples of IRD include deferred compensation amounts, distributions from an IRA or a qualified plan, renewal commissions of a life insurance agent and annuity payments or proceeds.

An income tax deduction for a portion of the estate tax paid is allowed in order to minimize the potential double taxation on IRD payments.[32] The amount of the deduction is calculated by determining the estate tax with the taxable portion of the IRD payment in the estate and the estate tax without the taxable portion of the IRD payment in the estate. The difference represents the amount of the deduction. It is important to remember that this is a deduction that reduces taxable income as opposed to a credit, which is a dollar for dollar reduction of the tax. The IRS in Publication 529 (page 11 of 2005 version) has indicated that income in respect of a decedent creates a deduction

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[29] Rev. Rule. 79-335, 1979-2 CB 292; PLRs 9346002 and 9245035.
[30] Reg. §20.2031-7(d).
[31] IRC §691.
[32] IRC §691(c).

that is not subject to the 2% limit and should appear on Line 27 of Schedule A (Form 1040).

X. Conclusion

Annuity contracts offer individuals the opportunity to save for retirement on a tax-deferred basis. These contracts, if annuitized, can help provide assurances that an individual will not outlive their retirement income. However, with these benefits comes a set of tax rules that are at times difficult to comprehend. These rules, however, must be understood to best ensure that any recommendations made will not inadvertently create an unintended and unwanted tax result.

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