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25 Common Annuity Planning Mistakes and How to Avoid Them

Presenter Name
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Agenda

- Annuities are powerful financial strategy tools
- Annuities solve a number of client needs
- Annuities enjoy tax-favored status in the Internal Revenue Code (IRC)
- But, like any area that's complicated, if you aren't careful, you can trip up

Mistake #1: Failing to understand that not all annuities are created "tax equal"

- The tax rules governing annuities are contained chiefly in Section 72 of the IRC and are very specific
- At various points in time, Congress has changed the rules governing how annuities are taxed
- Therefore, not all annuities are created equal in the eyes of the Internal Revenue Code!
- Let's look at some important examples…

Mistake #1: Continued…

- Withdrawals from pre-August 13, 1982 annuities get FIFO treatment and aren't subject to the 10% premature distribution penalty
- Withdrawals from post-August 13, 1982 annuities get LIFO treatment and are subject to the 10% premature distribution penalty
- The gift of an annuity issued after April 22, 1987 results in the policyowner being taxed on the gain
- Not so for annuities purchased before April 22, 1987

Mistake #2: Failing to capture an annuity's issue date when fact finding

- What's the significance?
- When fact finding, be sure to accurately capture the annuity issue date!
- One day's difference can make a huge difference for your clients and the IRS!

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Mistake #3: Failing to understand the difference between LIFO and FIFO taxation

- Withdrawals from annuities purchased before
- Withdrawals from annuities purchased after August 13, 1982 annuity get LIFO treatment!
  - “FIFO”= “first in, first out”
  - “LIFO”= “last in, first out”

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Mistake #4: Forgetting the basic rules of Section 1035 exchanges

- Section 1035 of the IRC contains the rules for effectuating a so-called “tax-deferred exchange” of life, annuity, and endowment contracts

Mistake #5: Forgetting about "LEA" & exchanging "Down the Chain"

- Sounds simple…
  - Changing contracts shouldn't be a realization event
  - Remembering "LEA" and "Down the Chain"
    - Life → Life, Endowment, Annuity
    - Endowment → Endowment, Annuity
    - Annuity → Annuity
    - Can't change up ↑ the chain, only down ↓

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Mistake #6: Section 1035's "Relate to the same annuitant" requirement

- Can you change the annuitant?
  - Life #1 ⟶ Life #2 ≠ valid 1035 exchange!
  - Regulation Section 1.1035-1(c) contains a "continuity of annuitant" requirement
  - Make sure you check to see whether the annuitants are the same!
  - With annuities, the owners must also be the same!

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Mistake #7: Multiple 1035 exchanges

- Can you exchange one annuity contract for more than one annuity contract?
- Section 1035(a)(3) describes the exchange of "an annuity contract for an annuity contract"
- The IRS has privately ruled that single-to-multiple 1035 annuity exchanges are permissible!
- Private letter rulings:
  - 200243047
  - 199937042
  - 9644016

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Mistake #8: Multiple 1035 exchanges, part 2

- Can you exchange more than one annuity contract for a single annuity contract?
- Can you "consolidate" old contracts into one new contract?
- Section 1035(a)(3) describes the exchange of "an annuity contract for an annuity contract"
- The IRS has privately ruled that single-to-multiple 1035 annuity exchanges are permissible!
- Revenue ruling 2001-75

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Mistake #9: Partial 1035 "Conway" exchanges

- Can you do a "partial" 1035 annuity exchange?
- Partial exchange: where than less than 100% of the existing annuity's value is transferred to the new annuity
- Conway vs. Commissioner (111 TC 350, 1998, acq. 1999-2 CB xvi) permitted partial 1035 annuity exchanges.
- Key question: does the carrier process both inbound and outbound partial 1035 exchanges?

Mistake #10: Why did I get a 1099?

- The IRS's 1099R instructions mandate that the replaced carrier prepare and file a 1099R
- The replaced carrier must disclose the:
  - "Total value" of the replaced contract and
  - "Total premiums paid"

Mistake #11: Did the replaced carrier check the correct box on the 1099?

- Don't let your clients get "boxed in"
- Code 6 in Box 7 is a critical entry because it notifies the IRS that a nontaxable transaction occurred!
- If a carrier entered the wrong code in Box 7, ask for a replacement 1099R ASAP!

Mistake #12: What to do if the carrier checked the wrong box on the 1099

- If your clients get “boxed in,” what do you do?
- If the replaced carrier entered the wrong code in Box 7, ask for a replacement 1099R ASAP with Code 6 in Box 7!

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Mistake #13: Making minors owners and/or beneficiaries of annuities

- Problems:
  - Minors don’t have the legal “capacity” to contract
  - Minors can’t exercise policy ownership rights
  - Minors can’t annuitize and make withdrawals
  - Don’t forget grandkids!
- Solution: make sure all kids and grandkids are over the age of majority!
- Solution: know when to use a UTMA/UGMA account

Mistake #14: Assigning or pledging an annuity

- The assignment or pledge of an annuity contract can result in adverse tax consequences to the owner!
- Section 72(e) of the IRC has a special rule dealing with the pledge or assignment of an annuity
- Any portion of an annuity that's assigned or pledged is treated like a cash withdrawal to the extent that the cash value, without regard to surrender charges, exceeds the investment in the contract

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Mistake #15: Gifting an annuity

- What happens if you gift a deferred annuity?
- If the annuity was issued after April 22, 1987, the excess of the cash surrender value over the premiums paid is taxable per IRC Section 72(e)(4)(C)!
- There are a couple important exceptions:
  - Transfers between spouses
  - Transfers between former spouse incident to divorce

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Mistake #16: What to say to advisors about annuity losses

- Can a taxpayer deduct losses generated by the surrender of a deferred annuity contract?
- There seems to be good authority for a loss deduction under IRC Section 165 when a deferred annuity is surrendered for less than the taxpayer's adjusted basis in the contract
  - George M. Cohan v. Comm'r, 11 BTA 743 (1928), aff'd 39 F.2d 540 (2d Cir. 1930).
  - Revenue Ruling 61-201, 1961-2 CB 46
  - IRS Publication 575
- The loss should be deductible to the extent that the taxpayer's miscellaneous itemized deductions exceed 2% of the taxpayer's adjusted gross income

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Mistake #17: How are corporate-owned annuities taxed?

- A flag should go up whenever anyone mentions an annuity being owned by a “non-natural” person
- In 1986, Congress changed the rules regarding deferred cash value buildup and annuities
- Annuities owned by “non-natural” entities such as corporations and LLCs lose their tax-deferred buildup
- IRC Section 72(u)
- In other words, the corporation could get a 1099!
- Partnership-owned annuities also lose deferred tax build-up (PLR 199944020)

Mistake #18: Annuities & Trusts

- Trust-owned annuities
- Can a trust own an annuity without losing tax-deferred cash value buildup?
- Exception to the rule for annuities where the “nominal” owner is not a natural person but the “beneficial” owner is a natural person
  - Grantor trusts (PLR 9752035)
  - Nominee trusts (PLR 9639057)
  - Secular trusts (PLR 9316018)
  - Testamentary trusts (PLR 199905015)
  - Nongrantor trusts (PLR 200449011)

Mistake #19: Failing to understand the creditor protection advantages of annuities

- Creditor exposure is a concern of many upscale clients
- Many states have a statute dealing with how much of an annuity (if any) is exempt from the claims of creditors and in bankruptcy, including both:
  - Annuity cash value and
  - Annuity income
- In a few states the exemption is unlimited, but some states put a cap on the exemption, which can be very low
- Bottom line: annuities can be very strong asset protection vehicles in some states

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Mistake #20: Forgetting about state guaranty associations

- State guaranty associations exist in all 50 states plus the District of Columbia and Puerto Rico
- Guaranty associations collect "assessments" from carriers depending upon the amount and type of coverage they write
- Many associations protect only policyholders who are state residents; some guaranty benefits of insurers domiciled in their state regardless where policyholder lives
- Dollar limits typically protect up to $100,000 cash value
- www.nolhga.com

Mistake #21: Forgetting the rules governing gifts of annuities to charity

- If an annuity contract is gifted to charity, the client must pay income tax on the gain
- IRC Section 72(e)(4)(C) and Revenue Ruling 69-102
- The client may be able to take a deduction for the full value of the annuity, but only after paying income tax on the gain

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Mistake #22: Forgetting the rules governing the charitable gift annuities (CGAs)

- Client transfers cash or appreciated property to a charity in return for the charity's annuity payment
- Why would a client do a “CGA”?
- Client gets: 1) charitable income tax deduction, and 2) basis cost recovery on every payment
- Do your due diligence!
- American Council on Gift Annuities website: www.acga-web.org to review how your state regulates charities offering CGAs
- Client could split their gift by doing ½ in a CGA and ½ with an immediate annuity from a highly rated carrier

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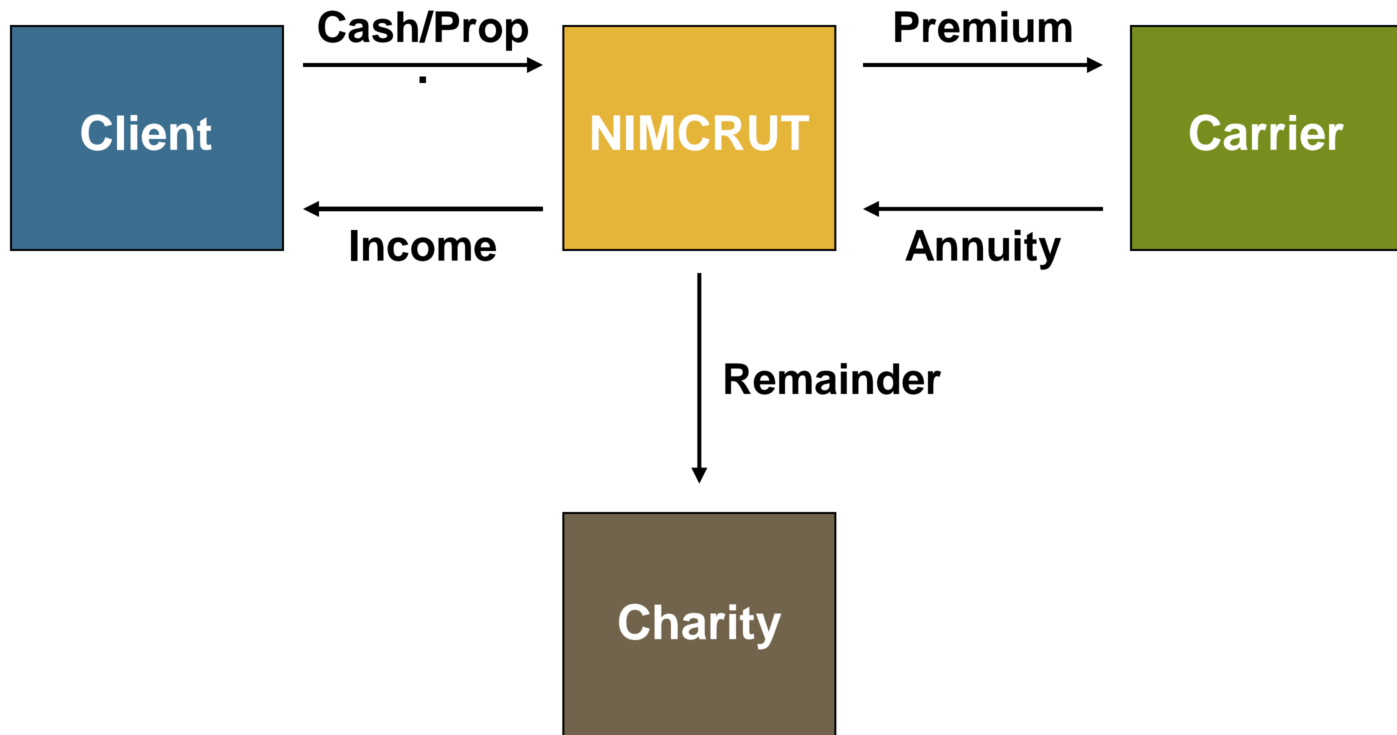
Mistake #23: Forgetting how annuities can be used in net income make-up charitable remainder trusts



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Mistake #24: Annuities and basis step-up

- Certain beneficiaries will be able to apply the exclusion ration to periodic payments
- The cost basis of annuities purchased prior to October 21, 1979 gets stepped up to the fair market value as of the date of the decedent-owner’s death
- Strategy pointer: Always check the annuity purchase date!
- Of course, if the annuity does not get a basis step-up, the annuity gain at death is Income in Respect of a Decedent (IRD)

Mistake #25: Annuities and Social Security benefits

- Social Security benefits can be taxed if the client's "modified adjusted gross income" (MAGI) exceeds certain thresholds
  - Joint filers pay tax on 50% of their benefits if they have a "modified adjusted gross income" that is between $32,000 and $44,000
  - If MAGI is more than $44,000, up to 85%of Social Security benefits are subject to income tax.
- The term "modified adjusted gross income" means AGI plus tax-exempt interest

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Mistake #25: Annuities and Social Security benefits, continued…

- Will the deferred buildup cash values inside an annuity cause a client's Social Security payments to be exposed to income tax?
- Under Section 86(b) of the IRC, the buildup of annuity cash values are not counted for calculating a taxpayer's "MAGI"!
- By contrast, tax-exempt municipal bond interest is counted in "MAGI"

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Summary

- We've discussed the various dates you should be aware of
- We covered the rules on 1035 exchanges
- Minors as annuity owners and beneficiaries
- Gifting and assigning annuities
- Creditor protection and guaranty associations
- CGAs and NIMCRUTS
- IRD and Social Security taxation

The Next Step

- Review the various strategy mistakes and opportunities involving annuities
- Review any of your own questionable client scenarios
- Be alert for any opportunities to correct other's strategy mistakes
- Protect your client's assets, as well as your own

Questions?

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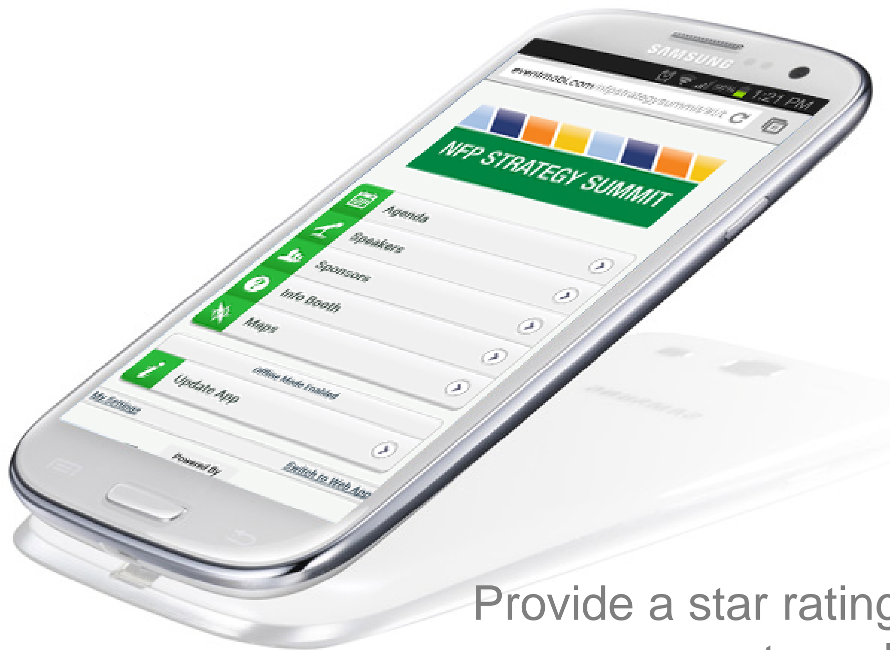

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