Annuities

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An *annuity* is a contract or agreement on the part of another person or company to pay another person (the annuitant) a fixed sum at periodic intervals usually for as long as the person lives or for a specified term of years.

The most important reason for purchasing an annuity is to ensure the annuitant an "income" for the rest of his or her lifetime without the burdens and risks of management. Many times individuals become concerned that their estate or assets will be used up or dissipated prior to their death, leaving nothing to live on. Also as we age the burden of management of our assets and especially investments in securities become difficult, if not impossible. An annuity can help alleviate these problems and concerns.

To understand annuities some terms or definitions will help.

Accumulation period: The time during which your fund builds up for a deferred annuity.

Annuitant: The person during whose life the annuity is payable, usually the person who is to receive the annuity.

Annuity: A contract that provides a fixed sum at periodic intervals for life or certain number of years.

Deferred Annuity: An annuity which payments begin at some future date.

Fixed Annuity: An annuity which the amount paid out is fixed sum and is usually guaranteed.

Loads: The fees or charges paid when you purchase an annuity. Includes sales commissions.

Mortality Table: A table showing the statistical death rates at each age.

Owner: The person who purchases the annuity.

Payout Phase: The period when income is received from the annuity.

Principal: The amount paid into the annuity (basis) as distinguished from the interest or growth inside the annuity.

Qualified Annuity: An annuity sold as part of a tax-qualified Keogh plan, retirement plan IRA, or TSA (403(b)).

Straight Life or Single Life Annuity: An annuity that pays a predetermined amount periodically (usually monthly) but ceases when you die.

Variable Annuity: An annuity which has security investment options for investment of the principal and where the periodic payments will vary based upon the performance of the stock or other investments.

There are two (2) types of annuities, commercial annuities and private annuities.

Commercial Annuities

Commercial annuities are sold by companies, primarily insurance companies. The annuity may be purchased for a single premium, in which case the annuity payments frequently commence immediately or the annuity payments may deferred to commence at some future date. Many times we see the date on which the annuitant reaches age 65 as a beginning date. The annuity may also be purchased where the purchaser pays a monthly or other periodic premium. In that case the annuity payments usually commence at a future date. Also an

annuity can be established from the transformation of a life insurance policy or the cash value in the policy may be exchanged for an annuity contract (1031 tax free exchange).

This exchange must be prior to the insured's death and the conversion into an annuity must be in accordance with the policy terms and the Internal Revenue Code.

There are two (2) major disadvantages in purchasing a commercial annuity compared to other investments. In the usual type of annuity, in which the annuity payments are fixed in amount, continuing inflation presents a serious problem.

The annuity will be paid for with "expensive" dollars, and the insurance company will pay it back with "cheap" dollars. In recent years, insurance companies have developed a so-called variable annuity, where theoretically at least, the payments will keep better pace with inflation.

The second major disadvantage of an annuity is its lack of flexibility. The annuitant may be faced with extraordinary expenses in any given month or other period, but the annuity payments will be made in accordance with the prearranged fixed schedule.

Commercial annuities are categorized by when the income begins, this is referred to as the "settlement".

An *immediate* annuity begins payments to the "annuitant" <u>within</u> 12 months of issue. These are most commonly purchased by people who have reached retirement age.

A *deferred* annuity begins payments to the "annuitant" 12 months or more after issue. These are most commonly purchased by people who have not yet reached retirement age.

The payout of an annuity are based upon the initial investment, plus interest or accumulation prior to and during distribution less the costs of administration. Several "settlement options" or methods of payout are offered by insurance companies.

A *straight life annuity* is one which ceases on the annuitant's death. It is not included in the annuitant's estate.

A *term annuity* is paid for a specific term i.e. 10 years. Under the "term certain" clause the annuity pays for the term stated regardless of the death of the annuitant.

A *joint life and survivor annuity* pays on the joint live say of a husband and wife. After the death of the first annuitant the payment may have to be reduced ("cut down"). Joint life annuities may have a portion of the value included in the deceased annuitant's estate, at least to the extent the deceased annuitant's contributed to the value of the annuity that is still to be paid after the deceased annuitant's death. See I.R.C § 2039.

Annuities, both straight life and joint life and survivor may also contain a "refund certain" clause. This guarantees the annuitant's beneficiary a refund any portion of the principal not paid out at the death of the annuitant.

Private Annuities

The term "private annuity" generally refers to an annuity (a payment in cash of a sum certain at least annually) for the lifetime of the annuitant by a purchaser of the property who does <u>not</u> otherwise issue annuities. The private annuity is contract between the annuitant and someone other than an insurance company or entity regularly engaged in the business of issuing annuity contracts. The most typical situation where a private annuity is used is when an elderly family member transfers assets to a younger family member who makes an unsecured promise to pay a lifetime annuity to the elderly family member.

One of the primary purposes of the private annuity is an estate planning tool to help reduce the estate owner's potential estate tax liability. The following are some of the advantages and disadvantages of using private annuities:

Advantages

1. The asset transferred will be kept out of the owner's estate, regardless of when the transferor's death occurs.

2. If the owner needs "income" during his or her lifetime, the annuity payments can satisfy this need.

3. A portion (the basis) of the annuity payments will be excluded from the owner's taxable income.

4. The private annuity may be used as a device to provide the estate owner with more liquidity during his or her lifetime. The asset transferred will immediately receive a new income tax basis to the purchaser equal to the then present value of the annuity payments to be made. If the asset produces little or no income, the purchaser could sell the asset at its then fair market value without paying an immediate capital gains tax and convert the asset to one that produces income. The owner, without using a private annuity, could not have made a sale of the underlying asset to a third party without the payment of a capital gains tax, which would have reduced the after-tax net proceeds.

5. When compared to a gift, the private annuity transaction results in no gift tax, unless the actuarial value of the annuity payments is less than the fair market value of the property. Moreover, if the owner had made a gift rather than a sale under a private annuity, the receipt by the owner of payments from the donee may have constituted a transfer with a retained life estate, causing the gifted assets to be included in the estate. See I.R.C. § 2036.

6. When compared to selling the property for a fixed price on the installment basis, nothing will be included in the owner's estate at the time of the owner's death. Under the installment sale, the unpaid balance of the purchase price would have been included in the estate.

Disadvantages

1. The owner may live too long, and the annuity payments will tend to increase the estate beyond what it would have been if the owner had kept the transferred asset.

2. If the owner lives longer than his or her life expectancy, the purchaser will have paid out more than the value of the asset.

3. The purchaser may not deduct any portion of the payments which he or she makes, even if they exceed the fair market value of the asset. Under an installment sale; however, the "interest" component of the installment note might be currently deductible.

4. If the annuitant dies substantially before the expiration of his or her life expectancy, the purchaser could receive a much lower income tax basis for the property than would have been the case if the annuitant died still owning it. The receipt of a lower basis may offset some of the advantage of keeping the asset out of the owner's estate.

5. When a private annuity is entered into to provide "income" for the owner, the promise to pay the annuity must be unsecured. The owner may have difficulty collecting on the contract and his or her objective may be unfulfilled. If the purchaser should die before the owner, the obligation would become a burden of the purchaser's estate. It might then be even more difficult to enforce, particularly if the transferred asset were the major asset of the purchaser's estate and he or she left a family which had been dependent on him or her for support. Whenever the estate owner is dependent on receiving the annuity payments for his or her own support, he or she should consider these

possible consequences before entering into a private annuity transaction.

Tax Considerations

Income Tax: The income taxation of annuities is governed by Section 72 of the Internal Revenue Code and the Regulations. These rules are very detailed and, particularly in the case of refund, term certain, and joint and survivorship annuities, there are many complex rules that require professional advice.

The basic principle is to permit the return of the purchaser's investment (basis) in equal tax-free amounts over the payment period and to tax the balance of the amounts received. As a result, each payment is in part a nontaxable return of cost and in part taxable income. To determine the nontaxable part, the "exclusion ratio" for the annuity contract must be determined. Such ratio is determined by dividing "the investment in the contract" by the "expected return." *See I.R.C § 72 (b).*

To discourage early withdrawals from an annuity contract, there may be a penalty tax of 10 percent of the amount included in income.

An annuity contract issued <u>after</u> January 18, 1985 must include specific rules for distribution in the event of the owner's death. The contract must provide that:

1. If the owner dies on or after the annuity starting date, any remaining undistributed portion of the annuity must be distributed at least as rapidly as under the method of distribution in effect at the owner's death.

2. If the owner dies before the annuity starting date, the entire interest in the annuity contract must be distributed within five (5) years of the date of death. However, the annuity may provide that distributions will be payable over the lifetime of the beneficiaries if such distributions are scheduled to begin within one (1) year of the owner's death. Moreover, if the beneficiary is a spouse of the owner, the annuity may be continued in the name of the spouse as the new owner (spousal rollover). See I.R.C. § 72(s).
If a contract issued <u>after</u> January 18, 1985, does not include these provisions, it will not be taxed as an annuity and the payment will generally be treated as income. *See Reg. § 1.72-1 (d).*

Gift Tax: One may purchase an annuity and make a gift of it to another person. If the donor gives it away immediately after the purchase, the value of the gift for gift tax purposes is the premium paid for the annuity. However, if the donor makes the gift at a later date, the value of the gift is the single premium the insurance company would charge at that time for a comparable annuity.

The value of an annuity on which premiums are still to be paid is the terminal reserve, adjusted to the date of the gift, plus the unearned portion of the last premium payment. See Reg. § 25.2512-6. Since the value of an annuity policy tends to increase with the passage of time, there is a tax incentive to gift these policies, even though such gift may be subject to immediate gift taxation.

One may also incur gift tax by purchasing a joint life and survivorship annuity. The amount of the gift is the cost of the annuity less the portion of the cost attributable to a single life annuity for the purchaser. See Reg. § 25.2512-6. If the donor reserves the right to change the survivor beneficiary, there will be no taxable gift.

When one spouse purchases a joint life and survivorship annuity and designates the other spouse as the survivor beneficiary, the gift tax marital deduction is allowed under the special qualified terminable interest property (QTIP) rules. *See I.R.C. § 2523(j)(6).*

The gift of an annuity contract issued <u>after</u> April 22, 1987 is treated as an assignment for income tax purposes. The donor of the annuity contract, at the time of the gift, must therefore include in such donor's gross income the amount by which

the net surrender value of the contract exceeds the investment in the contract. *See I.R.C. § 72 (e)(4)(C)*. The donee will receive a new basis in the contract equal to the donor's investment in the contract, plus the amount includible in the donor's income. *See I.R.C. § 72 (e)(4)(C)(iii)*. These rules do not apply if the gift is made to the donor's spouse or, if made in connection with a divorce, to a former spouse. *See I.R.C. § 72 (e)(4)(C)(ii)*.

Estate tax: A straight life annuity is not subject to death taxation in the annuitant's estate because it ceases on the annuitant's death, and there are no residual payments to be made to any other persons. However, annuities with refunds, term certain annuities, and joint and survivor annuities are subject to estate tax to the extent of the fair market value of the survivor's interest in the annuity.

If the amount to be paid after the annuitant's death is payable to the estate, the entire amount is included in the gross estate. *See I.R.C. § 2033*. When such amount is payable to a named beneficiary under an annuity purchased after March 3, 1931, it is includible in the estate only to the extent of the portion of the purchase price which the decedent paid. *See I.R.C. § 2039(a) and (b)*.

The value of the survivor's interest in the contract when issued by a company regularly engaged in selling these contracts is established through the sale of comparable contracts. If the contract was not issued by a company that regularly engages in that business, it is necessary to determine the present value of the annuity to be paid after the decedent's death by using the appropriate annuity valuation tables. See Internal Revenue Service Publication 1457 Actuarial Values Book Aleph (July 1999). A survivor's annuity payable to the surviving spouse will qualify for the marital deduction. *See I.R.C. § 2056(b)(7)(C)*.

Conclusion

Annuities are one of several tools used in estate and financial planning. Like all tools used they have advantages and disadvantages. Like CD annuities are a saving tool, they have better rates of return but the surrender period and charges are greater. Unlike a CD during the accumulation phase the taxation of growth inside the annuity is deferred.

Before purchasing an annuity you should seek professional advice. Speak with your financial advisor, and your attorney and CPA or accountant know the sale charges, the surrender periods and charges, any limits or guarantees on rate when the annuity is annuitized and the "settlement" options available. Also know the tax advantages as well the disadvantages for both income and estate tax of using or purchasing an annuity.