

USES OF COMMERCIAL ANNUITY PRODUCTS IN INCOME, ASSET PROTECTION AND ESTATE PLANNING

Presented by:
WEALTH MANAGEMENT ROUNDTABLE
&

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Basic Types of Annuities

- Three different types of annuities determined by the following:
 1. How the annuity is purchased;
 2. When the annuity payment is to begin; and
 3. How the cash value in the annuity is invested.

How the annuity is purchased

- Single premium – contract is purchased with a single premium or payment, no further premiums are required or allowed.
- Flexible premium – purchased with an initial payment and typically contemplates a series of premiums in whatever amount the purchaser wishes.

Payout options and tax treatments of both are identical, main difference lies in fact that additional contributions are not allowed in single premium contracts.

When payments are to begin.

- Immediate annuity – regular income – or annuity payments – within one year of purchase.
- Deferred annuity – paid out after one year from contract date and consists of two phases, the “accumulation phase” (the period from purchase to annuitization), and the “distribution phase” (the period from the commencement of payments until the cessation of payments).

How the cash value is invested.

- Fixed annuity – the contract values are measured in dollars and are guaranteed by the issuing company. The term “fixed” in fixed annuities refers not to the interest rate, but rather to the fact that contract values are measured in fixed units, namely dollars.
- Variable annuities – contract values are measured in terms of “units” either in accumulation units or annuity units, and values vary from day to day depending upon market conditions.

Parties to the annuity contract.

- Annuity company – party that issues the policy, and is obligated to all the promises made in it.
- Annuitant – the individual, and it must be an individual who is merely the “measuring life” for purposes of annuity payment calculations. They have no rights in the policy.
- The Beneficiary – party who will receive any death benefit payable (whether a lump sum or a continuation of payments.)
- The Owner – is the individual or entity (it need not be a human) that has all ownership rights in the contract, including the right to name the beneficiary or the annuitant.

Main tax benefit of a commercial annuity.

- Tax Deferred growth. Today's conversation will deal exclusively with "non-qualified" annuities, those purchased with after-tax dollars and not to fund IRA's or tax qualified retirement plans.
- Section 72 sets forth the favorable rules and regulations that provide for annuities' tax favored treatment, and, as we will see, a number of traps for the unwary.
- No specific line or provision of section 72 provides for tax deferral, rather, section 72(e) defines what amounts will be taxed as amounts "not received as an annuity." As growth in cash value is not included in the section 72(e) terms it is not taxable.

When does an annuity not get tax-deferred Treatment?

- Section 72(u) provides that annuity contracts that are held by an entity that is not a “natural person” will not be treated as annuity contracts for tax purposes and therefore all income earned during the year on such contracts will be taxable in the year earned.

Exceptions to the general rule.

- I am only going to cover relevant exceptions here:
 1. The annuity is acquired by an estate as a consequence of death of decedent;
 2. The annuity is purchased by an employer upon the termination of a qualified plan and held by the employer until all amounts under the contracts are distributed to the employee for whom the contract was purchased or to his beneficiary;
 3. It is an immediate annuity.

Exception to the exception.

- An annuity that would normally be treated as being held by a “non-natural person” shall be treated otherwise as a tax deferred annuity if the non-natural person holding the annuity is doing so “as an agent for a natural person.”

How does this apply?

- Non-natural person test – basically the service is looking to see if it is possible that a person, other than a natural born person, could be a beneficiary of a trust that is the owner of an annuity.
 1. In general a “revocable grantor trust” will fit within this exception because there is no real transfer for federal income or estate tax purposes.
 2. Similarly an “irrevocable grantor trust” should qualify for the same reasons as number 1 above.

How does this apply, cont.?

3. An inter vivos non-grantor trust was held to be the “agent for a natural person” of the annuities it purchased in PLR 200449011. Here the Service looked at the fact that, under the terms of the trust, there was no possibility that a person, other than a natural born person, could possibly be a beneficiary of the trust.

How does this work, cont.?

4. A testamentary trust was also held to be holding an annuity as agent for a natural person in PLR199905015. Here again, the Service looked principally to the fact that there was no possibility that anyone, other than a natural born person, could become a beneficiary of the trust in question.

5. However, the IRS has also indicated that the limited partnership will not be treated as holding an annuity as an agent for a natural person.

What does all of this mean?

- Trusts, if correctly drafted, can own annuity contracts and qualify for the favorable tax deferral benefits. This is a positive, and I believe, mostly untapped market because most advisors are simply too afraid to approach this area. A review of the underlying trust documents will determine if anyone, other than a natural person, could possibly be a beneficiary of the trust.
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ANNUITY IN ASSET PROTECTION

- Contrary to a popular belief annuities are not exempt from the claims in all situations.
- While it is true that under the laws of the Commonwealth of Pennsylvania annuities are exempt from the claims of creditors, this may or may not be true if a person files for bankruptcy.

Annuities in Asset Protection

- When an individual files for bankruptcy protection they must immediately choose between state and federal exemptions. There is no exemption for annuities from the claims of creditors, while, as mentioned earlier, there is a Pennsylvania State exemption for annuities.

Annuities in asset protection

- Thus if your client, who has an annuity, files for bankruptcy protection, and chooses the federal exemption, then the annuity will be part of the bankruptcy estate and subject to the claims of creditors.
- I have spoken personally with the Chapter 13 Trustee here in Pittsburgh and she has informed me that about 99% of bankruptcy filers choose the federal exemptions because of the other protections that they provide.

Annuities in Asset Protection

- Perhaps the best advice one can give here is to place annuities for asset protection purposes, into irrevocable asset protection trusts in an asset protection state such as Delaware. Then even if your client files for bankruptcy, the annuity has a substantially greater likelihood of escaping the grasp of creditors.

Annuities in Asset Protection

- This same thought must be given to those of you who may be using accounts receivable based leveraged life insurance for physicians. These same annuity exemption rules apply to life insurance with only small exceptions not worth mentioning here. Sold as a bare product they do not provide real asset protection.

Uses of annuities in Medicaid planning.

- As you are all aware the President signed into law the Deficit Reduction Act of 2005 (the “DRA”) on February 8, 2006. This law has profoundly altered the Medicaid planning landscape.

Under prior Medicaid planning law the purchase of an annuity was one of many methods of effective planning. The DRA has changed this landscape.

New planning alternatives!

- Under the new law a person who makes a “disposal of assets” can be subject to a period of ineligibility (the “POI”) for Medicaid. Unlike the old law, where the POI commenced on the date of asset disposition, the POI under the new law does not commence until the date the applicant would otherwise qualify for Medicaid. The look back period is five years.
- A purchase of an annuity is now presumptively deemed to be a “disposal of assets” that is subject to the POI unless the state is named a remainder beneficiary for at least the total amount of funds expended by the state on medical assistance, after the spouse or a disabled child. The annuity must be actuarially sound, irrevocable and non-assignable.
- It is very important to note here that a spouse may be named as the first beneficiary for her life. It is only after her death that the state jumps in line to receive any remaining payments.

Example

- I am not sure of this example but it's the most abusive I can think of and so let's try it.

Husband ("H") and Wife ("W") have a net worth of \$500,000 solely in cash and securities. H owns \$250,000 and W owns \$250,000. H receives \$12,000 in social security benefits and W receives \$6,000. Their income on the \$500,000 is \$25,000 per year. H is 75 years old and W, 72. H must go immediately to a nursing home that will cost \$75,000 per year. If H purchases an immediate annuity for W and properly names W as beneficiary with the state as residuary beneficiary, his \$250,000 will be properly excluded from the calculation of Medicaid eligibility.

What problems and benefits do you see with this example?

Annuity Tax Issues

The tax rules associated with annuities are complex and not always entirely clear.

Two main areas of inquiry:

1. Payment during life; and
2. Annuity payments after the death of the annuitant.

Annuity payments during the owner's life.

- Fixed Annuities - Taxable amounts are determined by reference to the exclusion ratio which is the total amount invested in the contract divided by the expected return.
- Variable Annuities – As the expected return amount is unknown the expected return is deemed to be equal to the amount invested in the contract. Thus all principal is returned first then all other amounts received are deemed income.

Taxation of Annuity!

Points to remember!

- Whose tax is it, anyway?

It must be remembered that the tax liability for payments from an annuity always remain with the owner, regardless to whom the payments are made, if the owner is living.

However, if the payments are made to the beneficiary because of the death of the owner, then the beneficiary is taxed on the payments.

Payment after death in “Payout Status”

- In this instance IRC section 72(s)(1)(A) requires that the annuity be paid out at least as rapidly as under the method being used on the date of death.

If the beneficiary receives a lump sum or in installments (other than payments calculated by application of a new annuity option) then proceeds are excludable from income by the beneficiary until the beneficiary receives the investment in the contract. All other income is taxable as ordinary income. Thus a FIFO (First In First Out) rule is used.

Payment after death, Annuity not in “Payout Status”

Here is a real trap for the unwary. Before we begin this discussion let us look at Code Section 72(s). **If you give any advice on annuities and don't understand what follows you can expect a catastrophe!**

Internal Revenue Code Section 72(s)(1)

- **(s) REQUIRED DISTRIBUTIONS WHERE HOLDER DIES BEFORE ENTIRE INTEREST IS DISTRIBUTED**
 - (1) IN GENERAL**
- **A contract shall not be treated as an annuity contract for purposes of this title unless it provides that--**
- **(A) if any holder of such contract dies on or after the annuity starting date and before the entire interest in such contract has been distributed, the remaining portion of such interest will be distributed at least as rapidly as under the method of distributions being used as of the date of his death, and**
- **(B) if any holder of such contract dies before the annuity starting date, the entire interest in such contract will be distributed within 5 years after the death of such holder.**

Section 72(s)

- As you will notice section 72(s)(1)(A) is the same general rule for annuities in payout status at the holder's death. The second rule, section 72(s)(1)(B) is the default rule for annuities not in payout status and applies unless an exception is available.
- Sections 72(s)(2) and (3) provide the two exceptions and neither exception is available unless the annuity is payable to a "designated beneficiary" as defined in section 72(s)(4) as "any individual designated a beneficiary by the holder of the contract."

Section 72(s)

- Section 72(s)(2) permits a designated beneficiary to take the proceeds over a period not longer than the beneficiary's life expectancy. Payouts are taxed based upon the exclusion ratio computed by dividing the annuitants remaining "investment in the contract" and the beneficiary's "expected return."
- Section 72(s)(2) also permits the use of the IRS "fractional method" of payment with a recalculation of life expectancy each year. This can result in a long deferral of income. Be aware of whether or not your policy allows for such payments.

Section 72(s)

- The second alternative to the five year rule only applies to a beneficiary who is a surviving spouse of the holder. Section 72(s)(3) permits the surviving spouse to treat the decedent's annuity as his or her own as if he or she were the owner from the inception. **Please note that this exception does not apply if the beneficiary is a trust to which the spouse is a beneficiary!**

Section 72(h)

A TRAP FOR THE UNWARY ADVISOR

- **(h) OPTION TO RECEIVE ANNUITY IN LIEU OF LUMP SUM**
- **If--**
- **(1) a contract provides for payment of a lump sum in full discharge of an obligation under the contract, subject to an option to receive an annuity in lieu of such lump sum;**
- **(2) the option is exercised within 60 days after the day on which such lump sum first became payable; and**
- **(3) part or all of such lump sum would (but for this subsection) be includible in gross income by reason of subsection (e)(1),**
- **then, for purposes of this subtitle, no part of such lump sum shall be considered as includible in gross income at the time such lump sum first became payable.**

Section 72(h)

What does this mean?

If the contract allows the beneficiary to take the proceeds as an annuity, in lieu of a lump sum settlement, and such person makes an election to do so within sixty days of the owner's death, then the annuity will be taxed to the beneficiary under the regular annuity rules. If the election is not made within 60 days from the owner's death, then the proceeds are entirely taxable, to the extent they exceed the investment in the contract, in the year of the owner's death regardless of the method of distribution chosen by the beneficiary.

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Section 72(h)

- There is a lot of argument over the real application of section 72(h) but the best advice is to simply be aware of the provision and make sure that the election is made within 60 days of the owner's death and thereby eliminate any potential problems.

Jointly held annuities.

- In general, and unless compelling reasons exist, annuities should not be held jointly.
- Why? Even though the asset passes automatically to the joint owner at the death of the co-owner, the payout rules and income tax consequences are dictated solely by the rules contained in Sections 72(s)(2) and (3).
- Moreover the spousal continuation rules of section 72(s)(3) will not apply if the surviving tenant is a spouse because the spouse must be a beneficiary and not an owner.
- Finally, if the annuity is owned by a husband and wife, and the beneficiary is their daughter, then, on the death of the first spouse, the daughter would be entitled to the proceeds of the annuity and not the spouse.
- Do not use jointly owned annuities!

Distributions of Annuities in Trust

- Types of trusts – Grantor, non-grantor, revocable, irrevocable, inter-vivos and testamentary.
- While many arguments have been made it appears that at least one line of thinking provides that when a trust is the beneficiary of an annuity there are only two distribution options.

Trusts and Annuity Distributions

- Annuity in “pay status”: If the annuity is in pay status then the distribution must meet the rules of section 72(s)(1) and the annuity must be distributed “at least as rapidly as under the method of distribution being used as of the date of his death.”

Trusts and Annuity Distributions

- Not in “pay status”: Under the Internal Revenue Code it appears that the only option available is that found in section 72(s)(1)(B) which requires a distribution within five years from the annuitant’s death.
- This is true regardless of who the beneficiary of the trust may be including a surviving spouse.

Trusts and Annuity Distributions

- A counter argument to the five year rule goes as follows:
One argument asserts that because Section 72(s)(2)(A), in defining when the annuitization option of section 72(s)(2)(B) will be permitted, requires only that the holder's interest be "payable to (***or for the benefit of***) a designated beneficiary", then, if the trust is acting as the "agent of a natural person," and if that natural person is the sole beneficiary of the trust, it follows that the trust is acting "for the benefit of" that "designated beneficiary" and should be able to take proceeds over a period not exceeding the life expectancy of that designated beneficiary, so long as payments commence within one year of death.