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Annuity Taxation: More Complex Than Meets the Eye

Income Tax Questions About Nonqualified Deferred Annuities

In an uncertain world, one of the few things planners can count on is demographics. Baby boomers will continue their march toward retirement—and will need and want a steady and certain level of income (and purchasing power) when they get there. This has led, and likely will continue to lead, to an increased interest in annuities (among other retirement planning vehicles).

We're going to do a two-part commentary on the taxation of annuities. In this first part, we've asked an expert on the topic, James Ivers, to share some comments on the seldom discussed and more difficult tax planning aspects of annuities. You'll find Jim's answers highly useful in your practice.

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The income taxation of annuity contracts can be a deceptively intricate area. Various placements of and transactions with these contracts can raise interesting and unexpected tax issues. In this column, we'll briefly examine ten of the more current and important income tax aspects of annuities.

It's assumed that readers have some familiarity with the basic principles of annuity taxation (including LIFO taxation on partial withdrawals, the exclusion ratio concept, carryover basis principles, and the nature of an exchange of insurance contracts under Section 1035).[1] In addition, because much of the authority discussed consists of private letter rulings, it is important to remember that such rulings cannot be cited as precedent, although they certainly provide a good indication of the IRS' thinking on a particular issue. Many of the situations examined in the rulings present opportunities to amplify the more familiar income tax benefits associated with annuity contracts.

Deducting a loss

SRL/AG: If an annuity contract is surrendered at a loss, can the loss be deducted?

Jim Ivers: Most financial services professionals assume that the surrender of an annuity contract can produce a taxable gain, but cannot result in a deductible loss. However, there is a rather obscure Revenue Ruling (not a private ruling) issued in 1961, Rev. Rul. 61-201,[2] which provides for the deductibility under Section 165 of an economic loss sustained upon surrender of a deferred annuity. This Ruling has not been revoked; in fact, it has been either cited or distinguished in subsequent Rulings on related issues, including Rev. Ruls. 72-193[3] and 80-268.[4]

In Rev. Rul. 61-201, the Service concluded that where a single premium refund annuity is surrendered, a loss deduction is available to the extent the amount received upon surrender is less than the owner's basis. The Service went on to say that the basis in the contract for purposes of determining loss was the cost of the contract less amounts received that were previously excludable from the recipient's gross income. This basis rule mirrors the definition of "investment in the contract" under Section 72(c)(1), which provides rules for the taxation of gain in an annuity.

Rev. Rul. 61-201 also states that such a loss is an ordinary loss, not a capital loss. Presumably, the loss—if available—would be reported as a loss from the sale or exchange of property other than a capital asset (Form 4797).

The annuity discussed in Rev. Rul. 61-201 was a single premium

refund annuity. The importance of the contract being a "refund" annuity (i.e., one containing a refund feature) would appear to be dubious in terms of the refund feature's relevance to the Ruling's logic in allowing a loss deduction. Nevertheless, the Service did observe that this specific Ruling applied only to a "refund annuity."

The question of whether the annuity was held by the taxpayer as an asset for the production of income and therefore eligible for a loss deduction under Section 165 was not specifically addressed in Rev. Rul. 61-201. But this issue was touched upon in Rev. Rul. 72-193, which distinguished Rev. Rul. 61-201 in deciding an issue that was subsequently covered by Section 72(b)(3) regarding the deduction for the unrecovered investment at the death of an annuitant. The IRS observed in Rev. Rul. 72-193 that an annuity is more likely to be an asset held for "profit" (rather than simply for the "security" of annuity payments), and therefore eligible for loss deduction treatment, if the contract owner continues to accumulate the funds in the annuity rather than taking annuity payments. Such is the case with the majority of deferred annuities in today's market.

Because variable annuities have suffered the pain of recent stock market losses, perhaps it is time for practitioners to take more notice of Rev. Rul. 61-201. Might the IRS disallow a loss deduction on a variable annuity on audit? Yes. Might claiming such a loss trigger an audit? That is certainly possible. On the other hand, does Rev. Rul. 61-201 provide substantial authority supporting a deductible loss? In my opinion, the answer is "yes."

Placing an annuity in a partnership

SRL/AG: Can a deferred annuity be held by a partnership without violating the "non-natural person" rule?

Jim Ivers: This question has often been asked since the enactment of Section 72(u) in 1986. That section provides that an annuity contract will not be treated as an annuity for income tax purposes, and will therefore be ineligible for the tax benefits provided to annuities, if the annuity contract is not owned by a "natural person" (i.e., a human being). That result, of course, is almost always unacceptable for planning purposes. This rule does have exceptions, including an exception for annuities held by "a trust or other entity as an agent for a natural person...."[5] If there is an applicable exception to the rule, the annuity will retain its income tax benefits. Hence, it is always necessary to be mindful of the "non-natural person" rule when considering placing an annuity contract in any entity.

The "agent for a natural person" and "beneficial owner" exceptions to the "non-natural person" rule have been the subject of many private ruling requests. The majority of these rulings have been pro-taxpayer. For example, many types of trusts have been found by the IRS to meet the "agent for a natural person" exception, including several varieties of grantor trusts, single beneficiary trusts, and other types.[6]

On the other hand, IRS rulings have been silent as to whether a partnership can hold a deferred annuity without jeopardizing the annuity's tax benefits. It is clear under the statute that corporate ownership of an annuity violates the "non-natural person" rule. There is no specific mention of partnerships in the statute.

In 1999, the Service announced that a taxpayer had withdrawn a letter ruling request on this issue after the Service reached the tentative conclusion that an annuity *held as partnership property by a* partnership may not be considered as held by an agent for a natural person.[7] Consequently, placing an annuity in the partnership would violate the non-natural person rule in the opinion of the IRS. Clearly, this was not the conclusion the taxpayer desired, so the ruling request was withdrawn. Unfortunately, this puts a chill on the prospects of placing annuity contracts in partnerships. The issue could still be litigated, even though in this situation the IRS wound up with the opportunity to make its position clear without actually ruling on the issue.

Tax effect of term rider

SRL/AG: What is the income tax treatment of an optional term life insurance rider issued as part of a deferred annuity contract?

Jim Ivers: Such a configuration, consisting of an annuity contract that included an optional term life insurance rider, was addressed by the IRS in Ltr. Rul. 200022003. Although the Service's findings are limited to the specific facts of the ruling request, the analysis and conclusions in this ruling chart some previously unexplored waters.

Taxation of the death proceeds under the term rider. The first holding in Ltr. Rul. 200022003 was that the proceeds payable

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[1] For more background, see *Tax Planning With Life Insurance* (800-950-3055) and *Tools and Techniques of Life Insurance Planning* (800-543-0874).

[2] 1961-2 CB 46.

[3] 1972-1 CB 58.

[4] 1980-2 CB 141.

[5] Section 72(u)(1).

[6] Ltr. Rul. 9933033; H.R. Conf. Rep't No. 841, 99th Cong., 2d Sess. Vol. II, 400-403 (1986), 1986-3 (Vol. 4) CB 400-403; Ltr. Ruls. 9905015, 9204010, 9204014, 9316018, and 9120024.

[7] See ILM 199944020.

under the term insurance rider will be excludable from the gross income of the beneficiary under Section 101(a)(1) as proceeds payable by reason of the insured's death. This means that regardless of the contract owner's basis in the annuity, the death benefit—if paid—is fully excludable from the gross income of the beneficiary. The primary reason given for this holding was that the term rider was, under applicable state law, a contract of life insurance separate from the annuity arrangement.

In the recent past, deferred annuity contracts that provide for pre-annuitization death benefits have typically not been formally structured with separate term riders. As a result, such death benefits have been taxable at the owner's death under Section 72 (the annuity rules), and not Section 101 (the death benefit rules). The policy in Ltr. Rul. 200022003 provides an innovative income tax-free death benefit that is payable under the overall structure of an annuity contract package. The income tax exposure of the gain in an annuity contract at the death of the contract owner (considering the carryover basis attribute of the annuity) has generally been considered one of the major disadvantages of owning an annuity.

Does the arrangement in this letter ruling provide an opportunity to avoid this traditional disadvantage? The answer is that it is a step in that direction, but not the final step. The ultimate solution may lie in future policy design. The problem with the contract design in the ruling is that cash withdrawals prior to the annuity starting date are not permitted under the terms of the contract. In other words, the only nonforfeitable benefits under the policy are the stream of payments at the annuity starting date, and the death benefit payable under the term rider. This significantly reduces the desirability of the arrangement. Nevertheless, it certainly seems possible that the design of such contracts could evolve to the point where some cash value would be available to the contract holder in addition to the income tax-free death benefit.

Taxation of contract funds used to pay for term rider. In Ltr. Rul. 200022003, the contract's term rider insured the life of the contract owner, and provided a death benefit for the owner's spouse payable if the owner died before the annuity starting date. Such a "pre-annuitization guarantee" has become common in annuity contracts, but has not always been designed as a separate life insurance contract under state law. This one was designed that way. The owner can either pay for the term rider with funds outside the policy, or use the annuity values to support the rider.

In the ruling, it was stipulated that if the latter option was chosen, term rider charges or "deemed distributions" would be taxable to the contract owner as amounts received from an annuity under Section 72. This means that amounts paid from contract values to fund the term rider will be taxable (and also subject to the 10% penalty if no exception applies) to the extent the annuity's cash value exceeds the investment in the contract at the time of the deemed distribution. That's a fair price to pay, it seems, for the tax-free death benefit under the annuity.

Distinguishing the term rider from a refund feature. Reg. 1.72-7 states that if an annuity contract contains a "refund feature," the taxpayer's investment in the contract for purposes of determining the exclusion ratio must be reduced by the actuarial value of the refund feature. A refund feature usually provides that, after the contract is annuitized, a specified number of guaranteed payments will be made to the annuitant's estate or a designated beneficiary regardless of whether the annuitant lives for the duration of the guaranteed payments.

But the term rider in Ltr. Rul. 200022003 (as well as other types of pre-annuitization guarantees) applies only if the owner dies before the annuitized stream of payments begins. This might be confused with a refund feature, but it is really a totally different type of feature. Thus, the basis adjustment for a refund feature need not be made with respect to a pre-annuitization guarantee payable upon the owner's death during the accumulation period of the annuity. In that case, what are the income tax consequences regarding basis in the contract if the contract funds are used to pay for the term rider?

Income tax basis for an annuity contract with a term rider. The letter ruling did not specifically address the question of how the presence of the optional term rider would affect the owner's investment in the contract (i.e., basis) for income tax purposes. At least two different interpretations of this question could be offered. First, the contract could be viewed as an integrated contract for purposes of determining basis. That would mean that all payments, including those to fund the term rider, would be included in the taxpayer's investment in the contract for purposes of determining the exclusion ratio or any other taxable transaction with the contract. Accordingly, as the contract goes forward in time, the funds used to pay for the rider would be counted as an investment in the contract in determining whether any future deemed distributions from the annuity to

carry the rider would represent taxable gain, or a nontaxable return of the investment in the contract.

If funds inside the annuity contract were used to fund the rider and were taxable to the contract owner under the LIFO treatment applicable to non-annuitized withdrawals (as the ruling stipulates they could be), the owner would at least get a basis increase in the overall contract as the funds were plowed back into it. This would be a tradeoff for the taxable event resulting from the deemed distribution. If, on the other hand, the distribution used to fund the rider was a nontaxable return of the owner's investment (where the contract contained no taxable gain to be taxed on a LIFO basis), then the overall effect of the deemed distribution would be a basis "wash": a decrease in basis for a nontaxable distribution, then a corresponding basis increase for the term rider payment.

Another interpretation could be that the funding of the term rider is separate from the taxpayer's basis in the annuity portion of the contract, and would not count as an "investment in the contract" for purposes of the exclusion ratio or other annuity taxation. This approach might be supported by the fact that the term rider is a separate contract of life insurance under state law.

The startling fact that the Service treated the entire package as an annuity contract for purposes of Section 1035 (relating to exchange of insurance policies, see below) supports the approach that the contract is integrated for income tax purposes and that payments to fund any portion of the package are included in the annuity's income tax basis. It probably makes more sense to apply this more favorable interpretation, although the answer is not completely clear. Practitioners should expect further developments with respect to both the contract design and tax implications presented in Ltr. Rul. 200022003.

Tax consequences at death

SRL/AG: Is the taxable gain includable in an annuity owner's estate treated as income in respect of a decedent (IRD) for income tax purposes?

Jim Ivers: This question involves annuity contracts other than those providing tax-free life insurance death benefits under a separate term rider as discussed above. The issue is whether the taxable gain that typically exists in a deferred annuity contract at the time of the contract owner's death will give rise to an income tax deduction under Section 691(c) for the amount of any federal estate taxes paid with respect to such gain.

In Ltr. Rul. 200041018, the Service concluded that the taxable gain resulting from the payment at the owner's death of a pre-annuitization guarantee under a deferred variable annuity contract will be treated as IRD and therefore eligible for the Section 691(c) deduction. Again, this death benefit was payable under the annuity contract itself and not pursuant to a term rider. The taxable amount equals the death benefit or total amount paid minus the owner's basis in the annuity contract. The taxable event occurs because annuity contracts are generally not eligible for a fair market value basis adjustment at the owner's death under Section 1014. This ruling provides a good result which helps to mitigate the unfavorable tax situation that often exists at the time of an annuity contract owner's death.

SRL/AG: What are the general rules for distributions of funds from nonqualified annuities at the owner's death?

Jim Ivers: The Internal Revenue Code contains distribution requirements that apply to nonqualified annuities at the time of the owner's death. These rules are found in Section 72(s). The rules are not the same as the minimum distribution requirements that apply to qualified plans of deferred compensation and IRAs. I'll briefly cover the rules applicable when the contract owner dies during the accumulation period (that is, before the contract has been annuitized). Somewhat different rules apply to contracts in which a stream of annuity payments has already begun.

First, if the contract provides that the owner's spouse will receive the entire interest in the contract at the owner's death, the spouse may continue the "deferral period." This means that the spouse may continue to allow funds to accumulate in the contract on a tax-deferred basis, and essentially stand in the shoes of the deceased contract owner for income tax purposes.

Second, if the beneficiary is a non-spouse beneficiary, the funds may be distributed in a lump sum, or over a five-year period, or over the life expectancy of the designated beneficiary commencing within one year of the owner's death. For distributions other than lump-sum distributions, the exclusion ratio rules under Section 72 will generally be applied to the periodic payments. If the contract owner is not an individual, the distribution rules are applied upon the death of the primary annuitant.

These rules illustrate that the optimal way of continuing tax deferral of annuity contract values after the owner's death is to have a spouse designated as the death beneficiary under the contract. Alternatively, the selection of a

younger person as the death beneficiary will maximize the tax deferral of the contract funds.

Gift of an annuity contract

SRL/AG: What are the income tax consequences of a donative transfer of an annuity contract?

Jim Ivers: Generally, the gift of ownership of an annuity contract is a taxable event for income tax purposes. The amount taxable to the donor is the excess, if any, of the contract's cash surrender value at the time of the gift over the owner/donor's investment in the contract (i.e., his or her basis). To the extent that gain in the contract is taxed to the donor in this fashion, the donee receives a corresponding increase in the donor's carryover basis in the contract. Otherwise, the donee's basis in the contract is the same as it was in the hands of the donor.[8]

Different rules apply to annuity contracts issued prior to 4/23/87. Gifts of such contracts do have income tax consequences, but there is no taxable event at the time of the gift. Rather, the donor is subject to a taxable event at such time as the donee subsequently surrenders the annuity. If and when that occurs, the donor will be taxed on the amount by which the cash surrender value exceeded the donor's investment in the contract at the time of the gift (not at the time of surrender). If that amount is less than the taxable gain in the contract at the time of surrender, the donee will be taxed on the balance of the gain. One can easily see why this cumbersome rule was replaced by the newer rules applicable to more recent contracts.

Exchanges of contracts

SRL/AG: Can an annuity contract be exchanged for a life insurance contract under Section 1035?

Jim Ivers: Section 1035 does not include "annuity contract to life insurance contract" in its definition of nontaxable exchanges of insurance products. It has, therefore, always been a precept that, unlike a "life to annuity" exchange (see below), an annuity contract cannot be exchanged for a life insurance contract under the nonrecognition provisions of Section 1035.

However, the Service came to a notable conclusion in this area in Ltr. Rul. 200022003, the ruling discussed earlier. In addition to ruling on the taxation of the term rider, the Service also determined that an annuity contract which did not contain a term life rider could be exchanged under Section 1035 for another annuity contract that did include the term life rider! This was the IRS' conclusion even though, as noted above, the term rider to the annuity contract was a separate contract of life insurance under applicable state law.

The Service expressly stated that the exchange would be treated as an "annuity for annuity" exchange, and made no mention of the term rider being treated as "boot" property which would normally result in partial recognition of gain. In so holding, the Service, in effect, allowed a partial "annuity to life" exchange under Section 1035! The implications of this conclusion are significant because in no other circumstance has the IRS given its blessing to the tax-deferred receipt of life insurance coverage in exchange for annuity ownership. Both financial services professionals and product designers should take note of this development. The only problem is that this portion of the letter ruling does not appear to be thoroughly reasoned. It's possible that the IRS could change its position on the issue.

SRL/AG: Can a life insurance contract be exchanged for an annuity contract under Section 1035?

Jim Ivers: This answer is easier—it is "yes." Section 1035(a)(1) specifically contemplates this type of exchange. The carryover basis rules apply in the same way as in a "life to life" or "annuity to annuity" exchange. Such an exchange may be beneficial where the owner of a life policy no longer needs death benefit protection, or in various other situations.

Furthermore, as a general rule, the taxpayer is permitted to pay additional money pursuant to any Section 1035 exchange to obtain a new contract. For example, the payment of additional funds pursuant to a "life to annuity" exchange does not jeopardize nonrecognition tax treatment. Only the receipt of money or property other than the new contract in the exchange will be treated as "boot."

SRL/AG: Will the number of contracts involved in a Section 1035 exchange of annuities affect the nonrecognition treatment accorded to the exchange?

Jim Ivers: In the case of exchanges of annuity contracts, as long as the primary annuitant is the same person or persons in each contract involved in the exchange, the number of contracts in the exchange does not appear to affect nonrecognition treatment. In the case of exchanges involving life insurance contracts ("life to life," or "life to annuity" exchanges), if each contract has the same insured person or persons, the number of contracts does not affect nonrecognition.

Regarding life to annuity exchanges, Treasury Regulations suggest that the insured on the life contract must be the same person

[8] See Section 72(e)(4)(C).

as the annuitant on the annuity contract received in the exchange.[9] Consequently, the issue is not the number of contracts involved in the exchange; rather, it is whether the "same insured" or "same annuitant" requirement is met.

It is permissible to have more than one contract on either "side" of a Section 1035 exchange. In each of the following private rulings, Section 1035 exchange treatment was granted:

- An exchange of two life policies issued by two different companies for one annuity contract issued by a third company.[10]
- An exchange of one single premium annuity contract for one single premium annuity contract and one flexible premium annuity contract.[11]
- An exchange of two annuity contracts for 26 (!!) annuity contracts.[12]

SRL/AG: Is it necessary to make a complete surrender of an annuity contract in order to qualify for a Section 1035 exchange?

Jim Ivers: According to the Tax Court in *Conway*,[13] the answer is "no." In *Conway*, the taxpayer made a partial withdrawal from an existing annuity contract issued by one insurance company, and transferred those funds to another insurance company to purchase a second annuity contract. Although the taxpayer specified in the paperwork with the second insurer that the transaction was intended as a Section 1035 exchange, the first insurer sent the taxpayer a Form 1099-R indicating that the transaction was taxable. About three years later, the first insurer sent a letter to the taxpayer indicating that it should have processed the transaction as a Section 1035 exchange. But by that time it was too late: the IRS was aware of the transaction and the parties were "off to the races."

The Service, however, failed to convince the Tax Court that a mere partial surrender of the first contract would disqualify the exchange from nonrecognition treatment. The court's opinion stated flatly that "neither Section 1035 nor the regulations condition nonrecognition treatment upon the exchange of an entire annuity contract...either expressly or by any necessary implication."

So, the taxpayer wound up with two annuity contracts and no taxable event—a surprising outcome. It had previously been assumed by many industry specialists and commentators that the concept of an "exchange" of contracts carried the intrinsic meaning that one contract must be completely surrendered in exchange for another. The IRS thought so; the Tax Court did not.

Many insurance companies are not set up administratively to handle a partial withdrawal from an annuity contract as a Section 1035 exchange. Such a technique is still a novel concept. It could be useful in many situations, including those in which the contract owner wishes to keep funds in an annuity wrapper, but diversify his or her investment opportunities by using different contracts. Moreover, surrender charges can be minimized in some cases using this technique.

What about applying the same concept to the other end of the exchange? In other words, could an annuity contract be surrendered in a Section 1035 exchange, and the funds from that contract placed into another existing (not new) annuity contract already owned by the taxpayer? Commentators have wondered about that question as well.

The opinion in *Conway* stressed the idea that the purpose of Section 1035 was to allow taxpayers to continue an investment in an insurance or annuity contract without recognition of gain, so long as they do not actually receive money pursuant to the transaction. This "flip side" of the *Conway* facts would appear to be in keeping with that thinking every bit as much as much as the *Conway* case itself. However, neither the IRS (who we can guess was not happy with the *Conway* decision) nor any court has specifically approved the idea of having an existing contract rather than a new contract on the other end of a Section 1035 exchange. Perhaps some enterprising taxpayer will be willing to test that issue.

Conclusion

The income taxation of annuities is anything but simple. We're very appreciative of the insight of Jim Ivers for helping to highlight some of the key issues and answers in this most important area and for sharing with us commentary on the taxation of some of the more creative planning techniques in recent years.

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9 See Reg. 1.1035-1(c).
10 Ltr. Rul. 9708016.
11 Ltr. Rul. 9644016.
12 Ltr. Rul. 6212194820A.
13 111 TC 350 (1998).