INSURANCE TRENDS AND TOPICS

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Annuities and Estate Planning

As we noted in our last column, there has been a very noticeable increase in clients' interest in and questions about the taxation of annuities (see 29 ETPL 308 (June 2002)). In that column, James Ivers addressed some of the key income tax issues. This month, we've asked another expert on the topic, Darlene K. Chandler, J.D., CLU, ChFC, the Director of Advanced Markets Administration Support at Farm Bureau Financial Services in West Des Moines, Iowa, and author of *The Annuity Handbook*, to share comments on the seldom discussed estate planning aspects of annuities. You'll find Darlene's comments extremely helpful in your practice.

The numbers

According to a survey done for the Committee of Annuity Insurers, the average age at which an annuity owner purchases his or her first annuity is age 50. Currently, the average age of all annuity owners is 65. Both of these statistics point toward the fact that most of us plan to use annuities to (1) save for our retirement and (2) pay out during that time. With this in mind, let's look at six issues estate planners should consider in planning for clients who already own or who are contemplating purchasing annuities.

Estate tax treatment of annuities

If you are engaged in estate planning, it is important to know how an annuity is treated for estate tax purposes. What happens, from an estate tax perspective, when the annuitant dies? Generally, if a person dies before the annuity payout period has begun and if the annuity death benefit is payable to the annuitant's estate, *the value of the* death benefit must be included in the gross estate for federal estate tax purposes under Code Section 2033.

If the annuity death benefit is payable to a named beneficiary, as would more usually be the case, the *value of the death benefit is includable* in the gross estate under Section 2039. But even if there is no living named beneficiary, if the annuitant/contract owner dies before annuity benefit payments commence, the value of the annuity will be included in the annuitant/contract owner's gross estate. This result assumes that the decedent *provided the full purchase* price of the annuity. If the decedent provided only a portion of the purchase price, then only a proportional share of the annuity's value would be included in his or her gross estate for estate tax purposes.

If the value of a nonqualified annuity is not one of the larger *items in an individual's total net* worth, the fact that the annuity's value must be included in the gross estate may not be a huge concern. But annuities are often held for many years—even decades—and the interest paid by the insurer on the annuity accumulates on an income-tax-deferred basis. So the annuity may have a considerable estate tax value. Therefore, ownership of such an annuity (or annuities) should not be overlooked during the estate planning process or in computing hypothetical probate liquidity needs.

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Impact of benefit payout option

If the annuity's payout period has already begun at the time of the annuitant's death, the estate tax inclusion results may differ. The outcome of the estate tax inclusion question depends on the type of benefit payout option that was selected. If the annuity was paying benefits under what is commonly referred to as a "life only" option, contractually, payments end at the annuitant's death. The "life only" payout option pays a benefit from the annuity only during the annuitant's lifetime. Upon the annuitant's death, the issuing insurance company has no further obligation to make payments. Because no further payments will be made, the annuity has no future value and nothing need be included in the annuitant's gross estate.

If, however, some other type of benefit payout option was selected, the annuity will have some value beyond the annuitant's death. For example, suppose that a "life and ten-year certain" payout option was chosen. Under this type of settlement option, the insurance company agrees to pay a certain amount of benefit for the lesser of (1) the annuitant's life or (2) ten years. If the annuitant lives for at least ten years beyond the time that benefit payments commence, the insurer will have no further obligation under the annuity contract upon the annuitant's death. So nothing will be includable in the annuitant's estate from that point on. On the other hand, if the annuitant dies after receiving only four years of annuity payments, the insurance company will be obligated to continue paying the annuity benefit to the beneficiary named in the contract for an additional six years.

If benefits that remain to be paid after the annuitant's death are payable to the decedent's estate, the value of these remaining payments must be included in the gross estate under Section 2033. If, as is more likely, the remaining payments are to be made to a named beneficiary, the value of these payments is includable in the gross estate under Section 2039, assuming the decedent provided the full purchase price of the annuity. The value of this annuity stream, for estate tax purposes, is generally the commuted value of the remaining payments.

Impact of gift of annuity

Now that we have reviewed the estate tax inclusion of nonqualified annuity proceeds or benefit payouts, let's analyze what happens when a gift of an annuity contract is made. The income tax consequences of making a gift of an annuity may not usually be considered as part of the estate planning process, although it is true that re-positioning assets often is involved in establishing, or even maintaining, an effective estate plan. And, of course, making a gift of an asset may be viewed as part of the re-positioning phase of estate planning.

With regard to the consequences of making a gift of an nonqualified annuity, there is a 4/22/87 cut-off date that is important to consider. This date pertains to when the annuity contract was issued rather than when it was transferred or, as is sometimes the case, the date when contributions were made. If a gift of an annuity contract issued *after* this date is made, the annuitant/donor may realize an income taxable gain in the year the gift is made. This gain is equal to the excess of the cash surrender value of the contract at the time of the transfer over the investment in the contract at that time.

Thus, astoundingly, to the great surprise of many clients—and their advisors—a *gift* of an annuity contract issued after the 1987 date may cause a current *income tax* consequence. If, in the course of planning an estate with an eye toward minimizing estate taxes, transfer of the ownership of an annuity contract seems attractive, it is important to remember this often unintended, and certainly not obvious, income tax result.

Interestingly, if a gift of an annuity contract issued *prior* to the 1987 date is made, an even more unusual income tax consequence may occur. In this instance, if the annuity contract's cash surrender value at the time of the gift is greater than the donor's cost basis and if the person who received the annuity contract as a gift decides to surrender the annuity, the *donor* must report as taxable income the gain that existed at the time the gift was made. In other words, the person who made the gift must report the gain in the contract at the time of the gift but not until the year in which the person who received the gift surrenders the contract.

This is a very dangerous tax trap, particularly since the donor may not even know if or when the donee cashes in the annuity. Years may go by before the donor becomes aware of a personal income tax liability triggered by the action of someone else. Worse yet, the event that triggers the need to pay tax does not create any cash for the donor to pay that tax.

Basis considerations

Generally, another factor that may influence estate planning decisions and recommendations is the basis of an asset. After the 2001 Tax Act,[1] looking at an asset's basis has become more important than before because of the possible repeal of the step-up-in-basis-at-death provision and the newly-created basis allocation choices that may have to be made by the estate administrator in some future year. Of course, what decisions may have to be made regarding the basis of estate assets may be affected by several items, including whether Congress takes action regarding the repeal of the estate tax, the year of the decedent's death, and whether the sunset provision of the 2001 Tax Act ever takes effect.[2]

Typically, the basis of a nonqualified annuity equals the premiums that have been paid into the annuity less any distributions that have been received and excluded from income during the life of the annuity contract. However, there is a limited exception to this rule that applies only to certain variable annuities. If the owner of a variable annuity contract that was purchased prior to 10/21/79 dies before the benefit payout period begins, the variable annuity contract takes a new cost basis. The beneficiary of the variable annuity contract will have, as a basis in the contract, a stepped-up basis. In other words, the beneficiary's basis in the variable annuity contract will equal the value of the contract on the decedent's date of death.

This result is in contrast to the general rule that the beneficiary of an annuity "carries over" the decedent's basis in the contract. Then, under the general rule, it is this carried-over basis that is used in calculating the exclusion ratio to be applied to the annuity payments to determine how much is—or is not—currently subject to income taxation.

IRA and qualified plan annuities

Up to this point, we have been talking only about nonqualified annuity contracts—that is, those annuity contracts that are not issued as part of any qualified retirement plan. Just for this portion of the discussion, let's look at some new final Regulations that do not apply to nonqualified annuities but rather affect Individual Retirement Annuities as well as most types of qualified retirement plans. These Regulations were issued under Section 401(a)(9) and deal with the calculation of minimum required distributions.

The minimum required distribution, or MRD, rules require that IRA holders and participants in most qualified retirement plans begin receiving at least a minimum amount from the IRA or plan at about age 70-1/2. The MRD rules have been known, for a number of years, as among the more complicated and difficult to work with. However, early in 2001, the IRS issued new Proposed Regulations, and in April 2002, published final Regulations.[3] These new final Regulations have accomplished two things. First, the MRD rules under the Regs. are actually simpler to work with.[4]

Further, and, perhaps more important from an estate planning point of view, the final Regulations have resulted in lower minimum amounts. Accordingly, if an individual is withdrawing only the minimum amount from an IRA or qualified plan each year, the new rules will create a greater likelihood that a portion of the balance in the IRA or plan will pass to his or her beneficiary. It is more likely that a balance will remain in the plan upon the plan participant's death because the minimum amount that was required to be taken out each year is now less than it was before the new Regulations. Obviously, the impact of these new lower minimum required distribution amounts will increase as time goes on and more years pass with the lower amounts in effect.

It is therefore important to make sure that the beneficiary designations are arranged so that, not only will funds in the IRA or plan at the holder's death go where the holder desires, but also that the

[1] Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16 (6/7/01).

[2] For an excellent discussion of basis issues under the 2001 Tax Act, see Kelley, "Basics of Carry-Over Basis," at http://www.leimbergservices.com. It's listed under the Estate Planning Newsletter tab as Commentary 384. See also the following very comprehensive article: Berall, Harrison, Blattmachr, and Detzel, "Planning for Carryover Basis That Can Be/ Should Be/ Must Be Done Now," 29 ETPL 99 (Mar. 2002).

[3] See TD 8987 (4/16/02).

[4] An MRD Calculator is available by calling 610-924-0515.

beneficiary designations are arranged to minimize taxation. A discussion of exactly what steps are involved in this process is beyond the scope of this commentary. However, since the new Regulations were issued, there have been a number of articles written which describe the necessary considerations.[5]

The private annuity

A private annuity is a type of annuity that is neither nonqualified nor part of a qualified retirement plan. Generally, a private annuity is an agreement entered into between two parties, neither of whom issues annuity contracts on a regular basis. (The annuity contracts, both qualified and nonqualified, that are issued by some type of entity—usually an insurance company—are sometimes referred to as "commercial" annuities.)

By entering into a private annuity, typically, one party agrees to pay the other party a sum for life. Generally, the party who will receive this annuity agrees to transfer property or some right to property to the individual who will be making the annuity payments. Hence, this is a sale in which property is exchanged in return for a promise. For example, a son might agree to pay his mother an annuity of a certain amount each month for the remainder of her life in return for an interest in an apartment building she owns.

The computations of the appropriate annuity payment and the income tax implications of the sale are calculations easily performed on a computer.[6] For estate tax purposes, it is useful to know that there is no value left in the private annuity at the annuitant's death (assuming a single life annuitant). Therefore, once the mother in the above example has died, her son would have no further obligation to make annuity payments. Consequently, much like the "life only" annuity settlement option discussed earlier, a private annuity results in no estate tax inclusion in the seller's gross estate. This makes it possible to remove very large amounts of property from a client's estate and works particularly well if a client's health is below average but the client is likely to live for longer than (a rule of thumb) two years.[7]

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[5] See *Tools and Techniques of Employee Benefit and Retirement Planning* (800-543-0874). An extensive commentary on this topic, "MRD Final Regulations Annotated," written by Attorney Noel C. Ice, and commentary by CPAs Robert S. Keebler and Barry Picker can be found at http://www.leimbergservices.com.

[6] Private annuity computations can be performed on NumberCruncher Software (610-924-0515)

[7] See *Tools and Techniques of Estate Planning* (800-543-0874) and *The Cutting Edge* (610-924-0515) for a detailed explanation of private annuities.