

What Can Your Clients Do with those Variable Annuity Losses?

By Chris Lloyd

Let's say that you have a client who invested \$100,000 (basis) in a variable annuity sometime during the last few years and now the surrender value is \$80,000. What can your client do with that \$20,000 loss?

1) Turn Paper Losses into Tax Free Gains

If your client 1035 exchanges that annuity to a new annuity then the first \$20,000 of gain in the new annuity is a recovery of basis and is therefore **tax-free**.

2) Your client may be able to deduct it.

IRC Sec. 72 does allow for an itemized deduction against income (not capital gains) for annuity losses. However, it seems clear that the reference is to life payout annuities from which the payee has not received a sum of payments equal to or greater than the cost basis of the annuity.

On the other hand, IRC Sec. 165 allows for itemized deductions for losses from activities that were "entered into for profit." Multiple tax advisors have told us that deferred annuities are generally deemed to be "entered into for profit" and therefore, if a policy is surrendered for a loss then the loss may be deducted against income (not capital gains) under IRC Sec. 165. Those advisors have also indicated that they have had practical experience defending that position in audits and the IRS agreed with their assessment.

Our answer to the deduction questions is a definitive, "We don't know for sure." As a result, we would strongly suggest that you have the client's CPA involved if you want to pursue this approach.

In either case, we know that some of your clients are begging you to get out of the market. Despite your best efforts to remind them of their original reasons for having that portion of their money in equities, some still insist on moving the money. We just thought that these two tax tidbits were worth keeping in mind when that time comes.

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