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Annuities

The Annuity Investment – Doing it Right!*by Paul M. League, QFP, CFP*

Annuities have many advantages, but they must be structured properly to achieve their fullest potential.

In this article, we'll look at the advantages and the possible pitfalls of investing in annuities. First, let's review the basics. Annuities are long-term investment contracts, which are issued and backed by insurance companies. They are designed primarily as fixed-rate or variable-rate savings vehicles. Fixed rate annuities offer a fixed rate of return, which is usually guaranteed for one year and adjusted annually or more frequently depending on the timing of deposits or other company-specific criteria. Index annuities are a variation of this type.

Variable-rate annuities are similar to mutual funds. They offer a variety of investment options and generate varying returns. Options for investing in variable rate annuity sub-accounts include conservative money market, fixed income, equities, and diversified portfolios. In some cases, these accounts are managed by large institutional money managers. The typical investor would not otherwise have access to these large institutional money managers because of large minimum investment requirements.

The key feature of annuities is tax deferral. Variable-rate annuities offer a greater potential for asset growth through investment sub-account options that are tied to market performance. They are best suited for long-term investors who are not risk averse. Variable rate annuity investments breathe with the market, meaning that performance rises and falls under changing financial market conditions. The exact weighting of invested dollars within variable rate annuity sub-accounts depends on one's risk tolerance and investment objectives.

Unlike bank CDs, annuities are not short-term investments because of penalties for early surrender or distribution. There are insurer-product penalties involving contingent deferred sales charges. They usually decline over a period of one-year to 15-years. However, some annuities have a surrender penalty. There are also IRS-imposed penalties equal to 10% on premature withdrawals/distributions, such as those before age 59 1/2.

Of these two penalty sources, it is only possible to avoid the 10% IRS penalty under Internal Revenue Code Section 72(q) and Code 72(t) for qualified plans. Your client can do this by taking equal distributions over at least five years or as long as it takes until they reach 59 1/2. This IRS penalty, which is a kind of balancing mechanism, is meant to prevent premature distributions. The Internal Code Regulations allow for the compounding advantages annuity tax deferral. The intent is to encourage the public to invest for the future instead of depending too much on Social Security or other government programs.

Generally, annuities are not suitable for estate planning, but are used to meet living and retirement income needs. There is an exception with charitable annuities through charitable-remainder trusts. They allow your client to transfer highly appreciated assets out of an estate to a charity to reduce capital gains taxes. Cash, securities, real property, or other assets are transferred into a trust. The trustee manages the trust assets and pays your clients or others whom your client has chosen, a fixed income for life or for a term of years. When the trust terminates, the remaining assets in the trust are transferred to the charitable organization.

Donors often use the income from the annuity to purchase life insurance in a separate life insurance trust, which is not part of the charity. This is done to create an estate or expand an estate on an income tax free basis upon the death of a donor. Many use the annuity as a kind of cash bucket to fulfill multiple needs, including the need for retirement income.

There is a 10% penalty when assets are taken before age 59 1/2, but many feel the benefits of tax deferral far outweigh these concerns. The penalty does not apply under the following conditions:

- There is a disability.
- Earnings on the investment were made before August 14, 1982.
- There was a series of substantially equal periodic payments for life that were not modified before age 59 1/2 or within 60 months if modified after age 59 1/2.
- Payments have been made to a beneficiary or to the annuitant's estate.

It is important to note that withdrawals on investments made into annuities issued after August 13, 1982 are treated as income first and are taxable as income. Some annuities have bonus products that offer investors immediate credits on a percentage of purchase payments. However, you must evaluate additional hidden charges very carefully when considering such product features.

How Annuities Differ From Other Investments

There are important differences between ordinary investments and annuities, such as investment objectives, relative risk characteristics, costs and expenses, liquidity, safety,

fluctuation in principal, return, guarantees, and insurance. However, a relevant difference between the annuity and, say, a mutual fund investment, is how they are treated under tax law.

First, let's consider the distinguishing product features or contractual provisions of annuities and mutual funds. Annuities have certain unique features for an added fee. Some annuities offer enhanced death benefit protection features, such as the following:

- Equal to or greater than the annuity value.
- The greater of 5% compounded annually.
- The largest annuity value on any policy anniversary date before the owner's death or their 81st birthday, whichever is earlier, minus any adjusted withdrawals.

Often, an owner/annuitant must be under 80 and have chosen this enhancement at time of purchase. Typical costs for these enhanced benefits are .15 to .25 basis points added to the annual mortality and expense charges, based on asset value, totaling 1.25% to 1.60%.

Additional features include the following:

- An array of pay-out options tailored to the contract holder's needs, including the right to annuitize the accumulated value over a lifetime or specified period.
- A death benefit that is not subject to probate and often protects beneficiaries against market downturns before annuitization.
- The same tax-deferral on any gains that you get with other qualified plans, but without the contribution limitations. Contribution amounts are not tax deferred if withdrawals and other distributions are received before age 59 1/2. A 10% penalty may apply.
- The ability to transfer among funding options without creating a taxable event for the investor.
- One-stop shopping with fixed income and stock/bond investment options combined in one account. It is the most common form in a variable annuity.
- Optional living benefit and death benefit features. In many cases, these features can limit market risk. They usually carry additional fees.
- Fixed sub-account alternatives with the potential to help reduce fluctuations in principle.

Added annual fees and charges for these benefits are imposed including mortality, expense charges, and a contract administration fee.

Mutual funds are investment products that serve various short-term and long-term financial needs. They earn money for an investor in several ways and can be taxed at different rates. Gains are generally taxable for the year earned. Capital gains and dividends may be taxed at a lower rate than the income tax rate. Interest is generally taxed at the income tax rate. Long-term capital gains and dividends are taxed at a maximum rate of 15%, while short-term capital gains and dividends are taxed at ordinary income rates ranging from 10% to 35%. They impose varying asset management fees, whether they are load or no-load funds. Additional features include the following:

- They generally offer more liquidity than do annuities.
- There is professional asset management similar to that of many variable rate annuity sub-account selections.
- There is a high level of diversification, which can be similar to many variable rate annuity sub-account selections.

Mutual funds and annuities have unique features, benefits, and charges. Perhaps the greatest single distinction between mutual funds and annuities is that annuities are insurance products whose capital gains, dividends, or interest accumulates tax-deferred and is taxed as ordinary income when withdrawn.

What about the tax costs of owning an annuity versus owning a mutual-fund investment? Mutual funds may appear to be tax-wise investments since maximum capital gains tax rates have been at a low 15% in 2006. But, don't overlook the tax costs of these two very popular investments. Fund investors have lost an average of 20% to 38% of their returns to taxes over the past 10 years according to recent reports by Lipper, which provides research on funds.

Mutual fund capital gains distributions are taxable in the year received even if your client has suffered losses. Mutual funds distribute profits near year-end. If your client bought shares before such a date, taxes may be due even if your client didn't benefit from any gains. Mutual fund investors who redeem shares at the same time can increase taxable capital gains distributions. Returns may be eroded when fund managers have to sell well-performing securities in order to pay these distributions. Mutual fund distributions can cause your client to lose tax deductions, exemptions, and credits if they increase their income to a point in which they no longer qualify. Mutual fund distributions can also trigger the alternative minimum tax. They may raise your client's income level and subject your client to a tax on 50% to 85% of their Social Security benefits.

An annuity can help your client avoid these negative tax issues because all of its investment gains accumulate tax-deferred. When earnings withdrawals are taken, taxes are paid at ordinary income tax rates. Withdrawals before age 59 1/2 are subject to a 10% federal tax penalty; early withdrawals may be subject to charge; and partial withdrawals may reduce contract benefits and the amount available upon a full surrender. With an annuity, 100% of any gains are tax deferred until distribution, giving your client the potential to stay fully invested to help grow their assets.

All appreciation with annuities is deferred and is paid out under a more favorable annuitization exclusion ratio. This ratio recognizes part of any annuity annuitization distribution to be a return of principle and therefore non-taxable. Annuities issued before November 21, 1979 benefit from a step-up-in-basis, but lose this advantage if they are ever 1035 exchanged.

Many investments are skewed to the rich, but annuities are long-term options. When

your client purchases an annuity as a non-qualified investment, they have the freedom to continue the tax deferral advantage up to the mandatory withdrawal barrier for traditional IRAs and qualified plans and beyond the age 70 1/2 mandatory withdrawal barrier.

Proper Annuity Structuring Considerations – Doing it Right!

All deferred annuities come in two contract forms – owner driven or annuitant driven. By “driven,” we mean that certain actions occur by contract upon death. These actions are beyond the control of named parties to the contract unless proper structuring is done regarding who is the owner, the annuitant, and the beneficiary to the contract. People must understand these structuring issues before investing in an annuity. To begin, first understand the type of contract that is used to make the investment and proceed cautiously from there.

Owners in owner-driven contracts have legal rights and can change the designated annuitant as needed, as the contract specifies, without any negative tax or penalties. It pays out only upon the death of an owner.

Owners can usually be changed under annuitant-driven contracts. However, it is contract specific as to whether it is possible to change an annuitant once the contract is issued. The contract pays out upon the death of owners or annuitants. In either form of contract, you client can always change primary or contingent beneficiaries.

Before proceeding further, we must understand two important rules that directly affect proper annuity contract structuring regarding the event of death. The “Death of the Holder Rule” states that annuity death benefits must be paid out upon the death of a holder. This is synonymous with the taxpayer/owner in any contract. The annuitant is considered the owner in the case of a non-natural trust-owner, but only for death distributions. This IRS rule applies to contracts issued after January 18, 1985 to prevent generational tax skipping. The rule later became applicable to any holder after April 22, 1987.

The “Spousal Continuation Rule” under Internal Revenue Code 72s states that a surviving spouse of a deceased owner can become the contract owner and continue the contract throughout their lifetime. This rule gives a deceased owner’s surviving spouse the right to continue building a tax-deferred asset for heirs. Therefore, the surviving spouse is not forced to take any assets until they want to. This rule is a meaningful exception to the Death of the Holder Rule. Not all insurance annuity contracts offer the spousal-continuation provision.

Problems can arise if your client has named primary beneficiaries other than a spouse. The option of becoming the contract owner and continuing is usually lost if anyone else is named as a primary beneficiary along with the spouse. When a child and spouse are named as primary beneficiaries, some companies will allow the spouse to continue the contract throughout their lifetime on the remaining portion of the contract. The Internal Revenue Code only states that the beneficiary is to be a spouse. However, some contracts specify that the spousal election letter will only be sent out if the surviving spouse is the sole beneficiary, which is a narrower interpretation of the Internal Revenue Code.

Death benefits can come in two forms:

1. Assets that have accumulated in the annuity investment.
2. Enhanced death benefits if the policy offers this feature and it has been purchased.

This may offer an even greater payout based on certain contract guarantees. The enhanced death benefits feature offers another advantage over many other kinds of investments. A key to death benefit payouts in the two policy forms we are discussing is knowing on whom the enhanced benefits are based. Does the owner or the annuitant trigger the enhancement?

In an owner-driven contract, death benefits are based on the death of the owner. In an annuitant-driven contract, death benefits are based on the death of the annuitant. What’s interesting with annuitant-driven contract forms is that distributions occur when the owner or the annuitant dies, which could bring about adverse income tax, gift tax, and premature distribution penalties to other named parties to the annuity contract. It could occur upon the owner’s death as distributions of annuity assets. It also could occur upon annuitant’s death as death benefits that are enhanced or not.

Why is any of this of interest to investors or advisors? In the typical husband and wife annuity investor scenario, spouses want to continue the investment until after the second spouse dies in order to pass remaining assets on to their children. But, without a correct contract, serious structuring problems can occur. You can avoid the following four main pitfalls of poor annuity structuring brought about by death:

1. Untimely income taxation.
2. Unwanted gift taxes.
3. The 10% IRS penalty.
4. Loss of the spousal right of continuation.

Let’s look at the following examples of identical structuring under owner-driven and annuitant-driven contract forms to see some of the problems that should be avoided when constructing owner, annuitant, or beneficiary contractual designations. As you will see, proper structuring is critical to the parties of an annuity contract. This example of an annuitant driven contract seems simple and benign, but it has a problematic spousal structure:

Annuitant-Driven Contract Form

Owner – husband

Annuitant – wife (also considered a

holder in an annuitant driven contract)

Beneficiary – husband and wife

The husband would become the sole beneficiary if the wife (annuitant) died first. But, he could not continue the annuity under the spousal-continuation rule because there would be no deceased owner spouse! For example, upon his wife's death, distributions would be forced upon the husband as the only owner and surviving beneficiary.

Here are typical examples of a faulty family structure:

Owner-Driven Contract Form

Owner – husband (age 60) and wife (age 50)

Annuitant – wife

Beneficiary – kids

Annuitant – Driven Contract Form

Owner – husband and wife

Annuitant – wife

Beneficiary – kids

Problem I

Under the annuitant driven contract, the kids get the payout if the wife dies before her husband. This may look fine, but it's not because the husband/owner is still living. He is subject to having made a lifetime gift to the children. After all, he owned 50% of the annuity. This creates adverse gift tax consequences in the year of the death to the surviving spousal owner. For example, it is like a reduction to the exemption equivalent. If the kids are under 59 1/2, they are also liable for the 10% penalty tax and ordinary income tax on any future income paid out of the contract. Upon the death of the annuitant, the beneficiary becomes the taxpayer, not the owner!

Problem II

In the annuitant driven contract, when the annuitant-wife dies, the surviving owner-spouse is considered to have made a gift to the beneficiaries (the kids in these cases) and income taxes become due. (Gifts between spouses are not subject to gift or income taxes.) When a non-spousal joint owner dies, the surviving owner maintains all owner rights over that contract. Under the Death of the Holder Rule, the surviving owner is subject to income taxes immediately on any gain in the contract. If there were no joint owners in an annuitant driven contract, there would be a 10% premature withdrawal penalty on the owner-husband if he was under 59 1/2 at the time of his wife's death.

Problem III

The children, not the surviving spouse, are now in full control of the assets!

Problem IV

Since a spouse is not the sole primary beneficiary, the surviving spouse loses the spousal right of continuation. Alternatively, in a jointly owned contract between spouses, your client could name the beneficiary as joint survivor owner and avoid losing the spousal continuation option.

Problem V

By naming any kids as contingent beneficiaries, the remaining assets would avoid probate. The problem is that they named the kids as beneficiaries, but named no contingent beneficiaries. That is a problem because otherwise, sole beneficiaries do not avoid any remaining assets.

There are remedies to these aberrant annuity structures, but it is not an easy road. Your client may want to cash out an improperly structured annuitant-driven or owner-driven contract during a down market when their principal is very close to their policy value so that there are minimal if any tax consequences (This does not apply to IRAs). The following methods are available: annuitization, amortization, and minimum distribution. Substantially equal periodic payment payout options (SEPP) can stretch out payments thereby lowering taxes. Remember that the exclusion ratio only applies on payments made under the annuitization method.

Some advisors may recommend a 1035 exchange of contracts. However, the law requires exchanges to have "like for like" structuring. It's generally not advisable to use the 1035 exchange on contracts that had a step-up-in-basis before October 21, 1979. But, it would be acceptable on contracts issued before August, 14 1982 since these are grandfathered. Withdrawals from these contracts are taxed first as return-of-basis and then as income. It is the concept of "first in principle, first out non-taxable principle" (FIFO). Bearing in mind these contract dates, let's assume that your client has an annuitant driven contract with an undesirable annuitant designation. Your client could

exchange it under a 1035 exchange for an owner-driven contract with the same owner and annuitant designation. You can correct the structuring of the annuitant after the contract is issued. In an owner-driven contract, the owner can change a faulty annuitant depending on the insurance company's contract. You can use other strategies, but the best way is to structure the contract properly from the outset!

Always structure an annuity to have the negative tax and penalties upon payout of the death benefit and have the most flexibility regarding those payouts. There are four payout options upon the death of the holder/owner: (These are not to be confused with the contract annuitization options.)

1. Lump sum within 60-days of death (insurer contract specific).
2. Five Year Rule (Code 72 Rule) – All money must be out of the contract at the end of five years.
3. Annuitize over the life expectancy, but make the decision within one-year (insurer contract specific). There are several options under this category, such as 10-year certain.
4. Spousal continuation of contract over the lifetime of the surviving spouse (Code 72 Rule).

There is an exception to the 10% before pre age 59 1/2 IRS penalty when it comes to death benefits/distributions that are paid out upon the death of the taxpayer/owner. But, is it not the same case upon the death of an annuitant. Remember, the appreciation of remaining contract assets over the five years is not treated as a death benefit. Therefore, net gains are taxable in the year earned. If they are under 59 1/2, the taxpayer/beneficiary is subject the 10% pre age 59 1/2 IRS tax penalty.

Always preserve these contract annuitization options. But, most importantly, preserve the spouses right of continuation to achieve the maximum pay out flexibility in structuring their annuity. The best way to keep this flexibility is to name a spouse as the sole beneficiary. With joint ownership of the annuity, your client can designate the beneficiary as the surviving spousal owner. If there are children, they should be named as contingent beneficiaries. This can also preserve three of the first four contract annuitization options for the children upon the death of the last spouse. The following are examples of a preferred family structure:

Owner Driven Contract Form

Owner – husband Annuitant – husband Beneficiary – wife Contingent – kids Annuitant Driven Contract Form

Owner – husband

Annuitant – husband

Beneficiary – wife

Contingent – kids

If the wife dies first, the husband simply names new beneficiaries – likely the kids – and maintains control over the asset. If the husband dies first, the wife is not forced to take distributions. She gets the asset and can continue the tax-deferral. Also, the children may get an even larger asset. This structure avoids each of the four pitfalls under an owner-driven or annuitant-driven contract.

It is best to name the older spouse as the owner. However, some clients object to making the other spouse the sole owner. A practical solution is to buy a separate contract on each spouse. In annuitant driven contracts, the owner and annuitant should be the same since the older spouse is likely to die first. According to mortality tables, a 50- to 85-year old woman is only likely to live about two to four years beyond a 50- to 85-year old man. However, as the spread in age differences increases, the older spouse is much more likely to die first. The incidence of death doubles with a 10-year difference in ages when the wife is the younger spouse.

Many designate trusts as beneficiaries of an annuity or even as contingent beneficiaries. First, there is no need to do this because annuities pass probate freely. Second, trusts do not allow for any form of spousal continuation or lifetime annuitization. This is because a trust is designated as a “non-natural person.” The Non-natural Person Rule applies to contributions into annuities after February 28, 1986.

Third, trusts limit payout to the lump sum within 60-days of death and the five-year rule. This reduces payout flexibility by 50%. It also impedes income tax efficiencies on what would otherwise be stretched out distributions that are taxed less. When designating a trust as the owner, it is important to know whether the insurance company that is issuing the annuity views the trust as a natural or non-natural person. This is especially important in revocable trusts (living trusts) in which there are spouses. Another problem with designating a trust as the owner of an annuity is that the insurance company will not allow for spousal continuation if it views the owner-trust as a non-natural person trust.

There are no “look-through” provisions on non-qualified annuities. Look-through provisions look through the grantor/trustee designation and recognize the spouse and spousal continuation rights. Look-through provisions only apply to IRS provided rationale for IRAs/qualified plans when a trust is the beneficiary. You should proceed very carefully when using a trust as any part of an annuity structure. Agents should require and obtain a written letter of instruction from the client's attorney on exactly how the attorney and the client want the structuring set up under an annuity contract.

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