Planning for Non-qualified Annuities

Presented by:
Robert C. Anderson, CELA, CAP

November 5, 2013
ESTATE PLANNING WITH NONQUALIFIED ANNUITIES

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Navigating the Labyrinth
Introduction

- Almost all clients buy annuities
- Tax rules complicate and obscure
- There is no Natalie Choate in this area
- Insurance companies follow their own rules
- Product complexity
- Definitional terms vary widely
- Continual new product offerings
- Aggressive marketing tactics
- Weak consumer protection laws
- What does “nonqualified” mean?
- Role of Elder Law Attorney
  - Evaluation & Advocacy
Why Annuities Are Like Cars . . .

- Moving Parts
- Confusing product variations
- Can crash
- Slick warranties
- Ineffective Lemon Laws
- Can trade them in

Both Cars & Annuities Have:

- Fixed Annuity is like a basic Chevy
- Indexed Annuity is like a Hybrid car
- Variable Annuity is like a Hummer
- Both make life easier
Key Advantages of Annuities

- Prevent the out-living of assets by annuitization
- Flexibility in lifetime settlement options
- Compounded growth with tax-deferral
- Owners have good control on when to incur tax
- Variable Annuities offer dollar-cost averaging, tax-free internal transfers and auto rebalancing
- Some annuities offer short surrender periods (3-4 yrs) and flexible waivers for ALF confinement
- Most annuities offer a guaranteed death benefit
- Flexibility in death-time settlement options – some tax help
The Fixed Annuity is like a Basic Chevy

Nothing Fancy ~ Lower Costs
The Indexed Annuity is Like a Hybrid Bar

Part Fixed ~ Part Variable Annuity
The Modern Variable Annuity is Like a Hummer

Multiple Guarantees Offer Protection ~but they come with a cost
Annuity Starting Date: “an artificial date of only historic significance.”

Owner: “King of the Hill”
- Need not have a heart beat
- Owner gets the money, not the annuitant
- IRC 72 uses “holder” and “annuitant”
- Impact on DRA’s “irrevocable” test

Annuitant: “Passive Spectator”
- Use of his/her life expectancy to time life-based payouts
- Must have a heart beat
- IRC/DRA confuses owner and annuitant

Beneficiary: “The Lucky One”
Two Phases of the Deferred Annuity
The Annuity Starting Date

Cash Accumulation Phase

Distribution Phase (pay-out)

Maturity Date (Annuity Starting Date)
Methods of Annuity Classification

How Annuity is Purchased
- Single Premium Annuity
- Flexible Premium Annuity

Timing of Benefit Payments
- Immediate Annuity
- Deferred Annuity

How Cash Value is Invested
- Fixed Annuity
- Equity Indexed Annuity
- Variable Annuity

Which Party’s Death Ends Contract
- Owner Driven Contract
- Contract is Both Owner & Annuitant Driven
- Annuitant Driven Contract
### Comparing Tax Rules of Qualified Plans During Life of Owner

<table>
<thead>
<tr>
<th>Item</th>
<th>Qualified Plans IRAs &amp; Employer Plans</th>
<th>Nonqualified Plans</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax Benefits for Contributions</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Limited Contributions</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Pre-59½ Rule</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Earnings are Tax-deferred</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Ownership Transfer</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Pre-death Withdrawals</td>
<td>100% Ordinary Income</td>
<td>Ordinary Income on Earnings; Then Tax Free Return of Capital</td>
</tr>
<tr>
<td>RMD 70½ Rule</td>
<td>Yes</td>
<td>No</td>
</tr>
</tbody>
</table>
Tax Rules
Payments to Owner-General

- Tax Rules for Distributions – Lifetime & Deathtime. There are three possible ways in which annuity payments can be taxed. For example, assume John invested $50,000 in an annuity and it has grown over the years to $100,000 and he now wants to withdraw $10,000.
• **Possible Rule 1 – Interest First Rule:** The entire $10,000 could come from the taxable accrued interest.

• **Possible Rule 2 – Cost Recovery Rule:** The entire $10,000 could come from the non-taxable investment.

• **Possible Rule 3 – Prorata Rule:** $5,000 comes from the taxable part and $5,000 from the non-taxable part. Many commentators call this payout method the “regular annuity rule” because it is the most typical method employed.
Specific Applications

Withdrawals:
- Interest First after 1982
- Cost Recovery for Pre-1982 Interest

Annuitzation:
- Prorata Rule
Other Important Pre-Death Rules

- **Annuities Owned by Trusts**
  - IRC 72 (u) – Paper Tiger

- **Ownership Transfers**
  - Immediate Taxability
    - New Owner enjoys tax-deferral
  - Usually does not trigger surrender charges

- **Non-Tax Surrender Charges**
  - 10% annual withdrawal exception
  - Penalty not deductible
  - Waived upon 90 day nursing home stay

- **1035 Exchanges**
  - Similar to 1031 exchanges
  - Carryover basis
  - Obtain a better contract
  - Compliance restrictions and agent abuse
  - Triggers surrender charges
  - Resets surrender clock

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2013 ADVANCED Elder Law Review
## Comparing Tax Rules After Death for Qualified & Nonqualified Plans

<table>
<thead>
<tr>
<th>Item</th>
<th>Qualified Plan</th>
<th>Nonqualified Annuities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Application of Stepped-up Basis</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>RBD Distinction application</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Lifetime stretch for trust beneficiaries</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Lifetime stretch for Individual Beneficiaries</td>
<td>Yes</td>
<td>Generally, No But can do level-payout for life</td>
</tr>
<tr>
<td>5 year deferral rule</td>
<td>Yes</td>
<td>Yes, but limited</td>
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### Income Taxation

#### Annuity Death Benefits

<table>
<thead>
<tr>
<th>Red Money</th>
<th>Pre-Tax dollars &amp; IRAs</th>
</tr>
</thead>
<tbody>
<tr>
<td>IRAs &amp; Qualified Retirement Plans</td>
<td></td>
</tr>
<tr>
<td>- 100% taxable</td>
<td></td>
</tr>
<tr>
<td>- No Stepped-Up Tax Basis</td>
<td></td>
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</tbody>
</table>

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<thead>
<tr>
<th>Green Money</th>
<th>After-Tax dollars</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stocks, Mutual Fund &amp; Land</td>
<td></td>
</tr>
<tr>
<td>- Not taxable</td>
<td></td>
</tr>
<tr>
<td>- Stepped-Up Tax Basis is Available</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Yellow Money</th>
<th>Partially after-tax dollars</th>
</tr>
</thead>
<tbody>
<tr>
<td>Annuities &amp; US Bonds</td>
<td></td>
</tr>
<tr>
<td>- Partially taxable to extent of earnings</td>
<td></td>
</tr>
<tr>
<td>- No Stepped-Up Tax Basis</td>
<td></td>
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</tbody>
</table>

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<thead>
<tr>
<th>Gold Money</th>
<th>After-Tax dollars</th>
</tr>
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<tbody>
<tr>
<td>Roth IRAs</td>
<td></td>
</tr>
<tr>
<td>- Not taxable</td>
<td></td>
</tr>
<tr>
<td>- Future growth is tax-free</td>
<td></td>
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</tbody>
</table>
- When Annuity was Already in Payout Status
  - Cost Recovery Rule Applied
  - IRC 72(s)(1)(A) at least as rapid rule
  - Exception: lifetime payout started in 1 year

- Spouse as Beneficiary When Annuity was Not in Payout Status
  - Lump Sum
  - Spousal Continuation
  - Five Year Rule
  - Payout Over Life
  - Prorata Rule Applied

- Non Spouse as Beneficiary When Annuity was Not in Payout Status
  - Lump Sum
  - Defer Over Five Years
  - Payout Over Life
  - Prorata Rule Applied
## Tax Code Time Limit Challenge

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<tr>
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<tbody>
<tr>
<td>• <strong>72(h)</strong> Requires 60-day Time Limit – for Annuitant and Owner-Driven</td>
<td>• <strong>Conservative Approach</strong> is to Comply with 60-Day Rule</td>
</tr>
<tr>
<td>• <strong>72(s)(C)</strong> – Force Out Rule Requires a One Year Time Limit – Only for Owner-Driven</td>
<td>• <strong>Proactive Planning</strong> Before Death</td>
</tr>
<tr>
<td></td>
<td>• <strong>Control Payout</strong> (predetermined)</td>
</tr>
<tr>
<td></td>
<td>• <strong>Evaluation and Advocacy</strong></td>
</tr>
</tbody>
</table>
Example 1: Annuitant-Driven Contract Before 1985
- Parent names Child as Owner
- Parent names Self as Annuitant
- Only Parent’s Death triggers Death Benefit

Example 2: Owner-Driven Contract
- Parent Names Self as Owner
- Parent Names Son as Annuitant
- Only Parent’s Death triggers Death Benefit

Example 3: Owner-Driven Contract
- Force-Out Rule of IRC 72(s)
  - Requires Pay-Out Upon Death of Owner Even if Contract is Annuitant-Driven
- Parent buys an annuity after 1985
- Parent is Owner & Annuitant
- Parent transfers Ownership to Son
- Contract Ends when Either Parent or Son Dies

Example 4: Trust Owned Annuity Becomes Annuitant-Driven After 1985
- Assume Trust is Owner & Parent is Annuitant
- Trust Cannot Die
- IRC § 72(s)(6)(B) Saves the Day. Annuitant Becomes Owner

Example 5: Planning Strategy to Avoid Force Out Rule for Owner-Driven Annuity
- Aging Owner/Annuitant Buys Annuity
- Transfers Ownership to Child – Parent is Still Annuitant
- Contract Continues After Parent’s Death
TRUST AS BENEFICIARY

- **Disadvantages of Trust as Beneficiary**
  - IRA look-through advantage not applicable (some exceptions)
  - Spousal continuation is lost
  - Payout over life is lost
  - IRC 5-year option may be denied by company

- **Advantages of Trust as Beneficiary**
  - Amount of Accrued Interest is Small
  - Blended family
  - Disabled or spendthrift spouse
  - Minor beneficiary
  - Disabled or spendthrift children or others
Basic Medicaid Issues with Annuities

- **Impact of DRA on Annuitization Strategies**
  - Income treatment may still be viable
  - State as beneficiary is required
  - Make sure Annuity is really irrevocable
  - State Implementation Varies

- **Surrender Charge Problem**
  - Waiver upon 90 days of confinement

- **Accrued Interest Problem**
  - Cleanse out income tax

- **Transferring Ownership**
  - Triggers income tax
Practice Tool Kit

- SAMPLE ADVOCACY ANNUITY QUESTIONNAIRE (WITH CONSENT)
- PITFALLS TO AVOID IN MAKING BENEFICIARY DESIGNATIONS FOR NONQUALIFIED ANNUITIES
- PITFALLS TO AVOID IN MAKING OWNERSHIP DESIGNATIONS FOR NONQUALIFIED ANNUITIES
- ESTATE PLANNING CHECKLISTS
Consumer Protection Advocacy
What Can We Do?

- Know your State’s “Suitability & Unfair Trade Practice Rules
- Attend “Medicaid Friendly” seminar
- File complaints with State Insurance Commission
- File Complaints with Securities Regulator
  - State
  - FINRA (Former SEC)
- Litigation – Refer to Expert
ESTATE PLANNING WITH NONQUALIFIED ANNUITIES:
NAVIGATION THE LABYRINTH

By Robert C. Anderson, CELA*

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I. INTRODUCTION

When our clients come to us for estate or Medicaid planning advice, nonqualified annuities are often a component of their portfolios. Sometimes clients ask our advice on the suitability of purchasing a commercial annuity proposed by a financial advisor. Sometimes advice is sought on proper beneficiary designations for existing nonqualified annuities. If Medicaid eligibility is desired, spend-down or annuitization strategies need to be addressed. Upon the death of a client, designated beneficiaries may seek advice on distribution options. All of these issues require familiarity with insurance company parlance and tax and other laws that apply to nonqualified annuities.

When a client’s annuity investment is substantial, Elder Law advocacy regarding the client’s and his/her beneficiary’s rights under such an annuity can be as important as drafting a Will or living trust for the client’s other assets. Such advocacy may entail reading the contract, interviewing the investment advisor, reviewing beneficiary designations and investigating compliance with State regulatory requirements.

This article expands upon the NAELA Annuity Task Force’s article published in the previous issue of the NAELA Journal (Vol. 3, No. 1, 2007), entitled Annuity Policy: Consumer Protection Issues and Public Policy Recommendations. This article will offer more practical advice to the Elder Law Attorney who wants to assist clients in navigating the rough waters of nonqualified annuities.

The term “nonqualified annuity” in this paper will be referred to as “annuity.” This paper will only address commercial annuities and not private annuities.

Annuities are more complex than bank, credit union, retirement plans, insurance, and most SEC-regulated securities. A typical variable annuity prospectus is over 90 pages of fine print, much longer than a typical living trust agreement drafted by an Elder Law Attorney. Definitional terms in annuity contracts, methods of calculating surrender charges, imposition of fees and charges, and many other contractual “moving parts” vary between insurance companies, resulting in difficult product comparisons. Definitional annuity terms also vary between insurance industry and federal statutory usage. New annuity products are approved by state insurance
commissions on a weekly basis. They are then offered for sale to the public, including senior citizens of all ages. In almost every corner of the U.S., so-called "Medicaid-friendly" annuities are marketed in connection with estate planning seminars presented by non-attorneys.

Consumer protection laws regulating annuities are in their infancy compared to laws for long-term care insurance and other financial products. (See Section 21). The tax rules for annuities are obscure and confusing. Many of the tax elections found in the annuity rules of Internal Revenue Code (IRC) §72, which provide for tax minimization, are not mandatory and are sometimes ignored by insurance companies offering annuity products. With such complexity, product variation, new product offerings, and aggressive marketing tactics, the typical senior citizen is at a loss to make informed choices about annuities.

Yet, annuities offer important advantages to senior citizens. The advantages and disadvantages of annuities are summarized at the end of this paper. (See Section 20).

Concise and forthright information, presented in a digestible format is paramount for informed decision-making in purchasing any investment; the purchase of annuities is no exception. Estate planning with annuities is replete with tax and other traps. This article is intended to assist the Elder Law Attorney in navigating clients through the virtual labyrinth of annuity planning.

II. ANNUITY AND NONQUALIFIED ANNUITY DISTINGUISHED

An annuity contract binds an insurance company to make a series of income payments at specified intervals in return for a single premium or series of premiums. Annuities are often bought for future retirement income. They can pay a guaranteed income stream that can last as long as you live.¹ Tony Webb, economist and annuity researcher, calls them "longevity insurance".²

Funds contributed to "nonqualified annuities" are made without a connection to employment. They are considered "after-tax" dollars because the individual contributing the funds cannot deduct the contribution. Funds contributed to "qualified plans," on the other hand, are made with a connection to employment, either to (1) tax-qualified retirement plans sponsored by employers, such as 401(k) and 403(b) plans in which employer contributions are excluded from an employee's taxable income, or (2) individual plans, such as traditional IRAs in which an employee receives an income tax deduction. These dollars are considered "pre-tax."

III. COMMON DEFERRED ANNUITY ELEMENTS

While there are a wide variety of "deferred" annuities, they all contain common characteristics and elements. They are contractual agreements. Deferred annuities possess two distinct phases. They enjoy special tax-deferred status. They make use of

surrender charges and tax penalties to discourage the use of the annuity as a short-term investment product. They require specific underwriting information in order to properly determine and fund the contract.

IV. TWO PHASES OF THE DEFERRED ANNUITY AND THE ANNUITY STARTING DATE

A deferred annuity is a contract with two distinct phases: cash accumulation, also called deferral, and distribution, also called payout. (See Figure 1). The accumulation period is the "build-up" period, after cash is invested in the company until the time it is withdrawn.

Subsequently, the payout period can vary in length. Should the owner/annuitant select a "Life Only, No Refund" payout and die soon after starting the payout period, the payment stream would cease. On the other hand, if such owner/annuitant began receiving annuity payments at age 60 and lived to age 100, he/she would receive payments for 40 years.

![Figure 1](image)

When a deferred annuity begins to make its payments to the owner/annuitant in a fixed settlement method, the Annuity Starting Date (ASD) has arrived and the annuity is now irrevocably annuitized. When this occurs, the owner/annuitant can no longer directly access the principal. He/she will continue to receive the cash payments in the amount stipulated by the contract.

The term ASD is now considered "an artificial date of historic significance". Formerly, the stated ASD was the maximum time limit of the deferral phase, at which time the payout phase had to start. It could always start earlier. Today, the ASD is typically extended by insurance companies past the date set in the contract. Therefore, it has very little relevance. For tax purposes, the ASD is simply the date when a deferred annuity’s payout period begins.

V. THE BASIC PARTIES

Insurance companies that write annuity contracts provide that there are three parties to annuity contracts: the owner, the annuitant and the beneficiary. Keep in mind that an annuity is a contract between the insurance company and the annuity owner.

---

3. Comment by Michael Messer, CLU, ChFC.
A. Owner

The owner makes decisions about the annuity, such as how much money to invest and how it should be allocated. The owner and annuitant are usually the same person, but they can be different persons. Sometimes the owner of an annuity is given another name in federal statutes, such as the "holder" in IRC §72(s) or the "annuitant" in IRC §72(c)(1)(C). The owner need not be an individual, and may be a living trust or other entity. The owner of a deferred annuity has all the rights to surrender the contract, make withdrawals, transfer ownership, designate beneficiaries, and elect annuitization options. When an annuity is annuitized, periodic payments are irrevocably paid out on a regular basis, similar to a pension or Social Security benefits. In most contracts, after they are annuitized, the owner can no longer surrender the contract or change the payout method, but can divert the payments to another and change the beneficiary designation. Some contracts also allow the owner to unwind his/her annuitization election.4

The owner's power to make changes to an annuitized contract may affect Medicaid planning under the Deficit Reduction Act of 2005 (DRA).5 DRA at 42 USC §1396c(1)(G)(ii) states that an annuitized annuity will be treated as an uncompensated disposal of assets unless, among other requirements, the annuity is "irrevocable and nonassignable." DRA does not define "irrevocable and nonassignable." The owner's power to make changes to an annuitized contract may allow a state to determine that the contract is an uncompensated transfer for Medicaid purposes. An Elder Law Attorney should confirm with the insurance company issuing an annuitized contract what rights the owner may have and whether these rights can be waived. A similar problem may result for contracts annuitized even before DRA's effective date of February 8, 2006. The owner's ability to change beneficiary designations after an annuity has been irrevocably annuitized may potentially permit a state to require a contract annuitized before DRA's effective date of February 8, 2006, to name the state as a remainder beneficiary on a recertification of Medicaid eligibility.6

Many companies allow two parties to be co-owners of an annuity, such as a husband and a wife. The drawbacks of such an arrangement are discussed later. (See Section 15).

B. Annuitant

The annuitant is the person whose life expectancy is used to set the "timing or amount of the payout under the contract."7 In other words, the life of the annuitant is the measuring life for the annuity. Therefore, the function of the designated annuitant is a passive role, similar to the function of the insured party in a life insurance contract.

---

4. Comment by John Olsen, CLU, ChFC, AEP.
6. New 42 USC § 1396p(e)(1) (2006) requires upon recertification a statement that the State is named as a remainder beneficiary.
The annuitant has no power to change beneficiary designations, make transfers, or elect payout options.

The annuitant designation will only affect the annuitization phase of a deferred annuity. At the point of annuitization, the life expectancy of the annuitant will determine the payout period if one of the "life-based" payout options is selected, e.g. Life Only, No Refund, Life With Period Certain, Life Annuity With Refund and Joint and Survivor Option. (See Section 9).

While the owner and annuitant are usually the same party, they can be different persons. If they are different parties and the owner elects to receive annuity payments, it is still the annuitant’s life expectancy that controls.

Example: An 85-year-old man owns a $100,000 deferred annuity and names his daughter, age 50, as annuitant. The father elects to annuitize using a Life, With No Refund. Even though the father will receive the payments, they will come in amounts based on his daughter’s longer life expectancy.

Sometimes the term “annuitant” as used in statutes is actually the “owner” as used in the insurance contracts. For example, in IRC §72(c) (1) (C) and in 42 USC §1396p (c) (1) (F) of the DRA, the term “annuitant” is the party who receives payments under an annuitized contract, but clearly this party is actually the owner of the contract. This definitional blur results from the fact that in most contracts, the owner and the annuitant are the same party and the terms are used interchangeably.

Since the annuitant is the measuring life for the contract, it is clear that the annuitant, unlike the owner and beneficiary, “must be a real flesh-and-blood person.” The annuitant designation in “annuitant-driven” contracts is irrevocable. In many “owner-driven” contracts, however, the owner may change the annuitant designation. (See Section 13 for an explanation of the difference between annuitant-driven and owner-driven contracts).

C. Beneficiary

Upon the death of the owner or annuitant, the beneficiary is the one who has the right to receive the death benefit.

VI. TAX-DEFERRED STATUS VS. STEPPED-UP TAX BASIS

Whatever type of deferred annuity is selected, they all enjoy tax-deferred status while in the accumulation period. When the annuity begins its payout phase, only the interest portion is taxable and the return on the invested funds is not.

However, at death of the owner/annuitant, the taxable portion of the account balance received by designated beneficiaries is treated as Income with Respect to a Decedent (IRD) under IRC §691. As such, an annuity death benefit will not receive a stepped-up basis under IRC §1014. (See further discussion in Section 12(a)).

VII. SURRENDER CHARGES AND TAX PENALTIES FOR EARLY WITHDRAWALS

In order to discourage the use of annuities as short-term investments, deferred annuities have two disincentives for taking early withdrawals. The first is a 10% penalty tax imposed by the IRS for withdrawals made prior to age 59½. Certain situations exist in which this tax penalty is waived, such as death or disability. (See later discussion in Section 10(n)).

The second disincentive is the surrender charge. The surrender charge is levied by the insurance company and has nothing to do with tax law. In fact, this surrender charge is not tax-deductible. Depending on the company’s policy, surrender charges will typically decline over a period of years and eventually phase out. A typical schedule for surrender charges can look like the following:

<table>
<thead>
<tr>
<th>Year</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>First year</td>
<td>7%</td>
</tr>
<tr>
<td>Second year</td>
<td>6%</td>
</tr>
<tr>
<td>Third year</td>
<td>5%</td>
</tr>
<tr>
<td>Fourth year</td>
<td>4%</td>
</tr>
<tr>
<td>Fifth year</td>
<td>3%</td>
</tr>
<tr>
<td>Sixth year and thereafter</td>
<td>0</td>
</tr>
</tbody>
</table>

Some modern contracts offer shortened surrender periods, such as three or four years. Some contracts offer reduced penalty percentages, such as 4%.

A. Internal Costs vs. Surrender Charges

As a general rule, if a company offers a favorable reduced surrender period or percentage, the company will have to recapture this potential loss by increasing annual internal expenses.

Surrender charges are usually, but not always, waived upon the death of the owner/annuitant and for certain other reasons. (See discussion in Section 10(n)).

VIII. CLASSIFICATION OF ANNUITIES

Classifications of Annuities are generally determined by (See Figure 2):

a. how the annuity is purchased;
b. when annuity payments are to begin;
c. how the cash value in the annuity is invested; and
d. which party’s death ends the contract.

---

A. How the Annuity is Purchased

There are generally two options in purchasing an annuity. A Single Premium annuity is a contract purchased with a single payment or premium. No further premiums are required. A Flexible Premium annuity is purchased with an initial payment (to establish the contract) and typically contemplates a series of premiums that may be paid whenever, and in whatever amount, the purchaser wants.
There is very little difference, if any, in the important policy provisions, guarantees, and payout options of the two types, and their tax treatment is identical.

B. When Annuity Payments are to Begin

An immediate annuity is one in which regular income— or annuity payments— to the owner begin within one year of purchase. Another label used to describe an immediate annuity is a payout annuity. An immediate annuity has no accumulation phase.

A deferred annuity is one in which periodic annuity payments are deferred beyond the first anniversary date of purchase— perhaps much later. The life of a deferred annuity is divided into two phases: the accumulation phase and the distribution phase, also known as the payout or annuitization period. (See earlier discussion in Section 4). The owner has different options in annuitizing the contract (see “Types of Annuity Payout Options, Section 9”)

Understanding the difference between an annuity contract’s required ASD (i.e. the date by which annuity payments must commence, absent an election to defer annuitization) and when annuitization is permitted under the contract, is critical. The owner can always elect to annuitize a deferred annuity at any time before the ASD.

C. How the Cash Value in the Annuity is Invested

1. Fixed Annuities

In a fixed annuity, the investment in the contract is guaranteed by the issuing insurance company. There is a common misconception that “fixed,” in the term “fixed annuity,” refers to the rate of interest credited to the contract. In fact, most “fixed annuity” contracts only guarantee interest rates for a few years. Rather, the term “fixed annuity” properly refers, not to the interest rate, but to the fact that the owner’s initial investment in the contract is not subject to market risk.

The basic investment difference between fixed and variable annuities is that in a fixed annuity (either immediate or deferred), the contract owner is offered no investment choices within the contract and assumes no investment risk, whereas in a variable contract the owner trades market risk for investment selection. In a fixed deferred annuity, the cash value (which includes all premium payments and prior interest credited) is guaranteed against loss. All fixed deferred annuities also offer a minimum interest rate guarantee. Some (but not all) fixed contracts guarantee the current declared rate for a certain period of time.

The investments used to fund a fixed annuity are fixed securities, such as debt instruments.

2. Equity Indexed Annuities

Equity indexed annuities (EIAs) are a hybrid form of fixed annuities. An EIA earns interest at a rate based on the performance of a stock market index, such as the Standard & Poor’s Composite Price Index (S&P 500). However, EIA performance is not identical to index performance. The S&P 500 does not reflect dividends paid or the compound reinvestment of dividends; therefore, an EIA that is indexed with the S&P 500 would generally have a lower return than would direct stock investments.

Rather, the EIA offers a guarantee of principal like a traditional fixed annuity, with the potential of higher returns resulting from indexing with a stock market index. The fact that the EIA combines features of a fixed and variable annuity together has led some commentators to describe them as a “blended” type of annuity. To insure against an adverse stock market environment, EIAs usually offer a guaranteed minimum interest rate, such as 3%.

There are features of EIAs that bear note. Hidden in the sales material, many EIA contracts contain “moving parts” that shrink the annuity’s return. Sales commissions are generous. As a result, the companies may require longer than normal surrender periods.

3. Variable Annuities

With a variable annuity, the annuity owner receives varying rates of interest and, depending on the investment options available at the time of annuitization, distributions may vary in amount. The owner of a variable annuity assumes the risk associated with investment decisions.

The market risk associated with variable annuities can be reduced or eliminated by purchasing optional enhancements offered by some variable annuity contracts. These risk-reducing enhancements can include (1) guaranteed minimum income benefit, (2) guaranteed minimum accumulation benefit, and (3) guaranteed withdrawal benefit. Enhancements that increase the death benefits payable can also be purchased.

One major difference between the fixed annuity and the variable annuity is that a variable annuity is considered to be a “security” under federal securities law and is therefore subject to a greater degree of regulation. A seller of a variable annuity must have the required securities license. Any potential buyer of a variable annuity must receive a prospectus (i.e., a detailed document that provides information on the variable annuity and the investment options available). Further, the seller must ascertain that the variable annuity is a “suitable” choice for the individual purchaser.

One critic of variable annuities points out that they compare unfavorably with stocks and mutual funds, because they convert capital gains (taxed at a fixed 15% rate) into ordinary income and have higher expenses compared with mutual funds.

11. Chandler, supra note 9 at 94.
12. Lyn O’Shaughnessy, Equity Indexed Annuities can Come Back to Bite You if Cash Needed, TownHall.com (Aug 8, 2006).
D. Which Party's Death Ends the Contract?

1. Annuitant and Owner-Driven Annuity Contracts

This classification is based upon which party's death is linked to the payment of the contract's death benefit and the contract's end. There are three types of annuities under this classification: (1) owner-driven, (2) annuitant-driven, and (3) owner or annuitant-driven contracts. This feature is a design option made by the insurance company rather than by the annuity purchaser. An annuity contract that pays a death benefit upon the death of the owner is referred to as an owner-driven contract. A second type of annuity that pays a death benefit upon the death of the annuitant is referred to as an annuitant-driven contract.

As will be explained in greater detail later in Section 13, as a result of a tax code change, all annuities issued after January 18, 1985, must be owner-driven. Despite this, after January 18, 1985, some companies continue to design annuities as annuitant-driven. Such an annuity falls into a third category. It pays out a death benefit upon the first death of the owner or the annuitant.

The distinction of owner versus annuitant-driven annuities is without impact when the owner and annuitant are the same person (the usual case), because the death benefit will be triggered regardless of whether the contract is annuitant or owner-driven. When the owner and annuitant are different individuals, the triggering of the death benefit will depend upon which party dies first and whether the contract is annuitant or owner-driven. Tax and forced payout consequences are impacted by these designations. (See further discussion in Section 13). The Elder Law Attorney should help a client determine whether a proposed or an already purchased annuity contract is owner or annuitant-driven, or both. This question can be answered by reviewing the annuity contract, itself. However, it is good practice to demand a written synopsis of any questions regarding the annuity from both the investment advisor and the insurance company's central office. This classification only applies to deferred annuities, not to those in payout status.

IX. TYPES OF ANNUITY PAYOUT OPTIONS DURING OWNER'S LIFETIME

An immediate annuity, or a deferred annuity that has been annuitized, produces an income stream. The nature of this income stream can vary according to the payout election made by the owner.

A. Life Only, No Refund (Straight Life)

This election provides lifetime guaranteed income. At death, no further distributions are made. Life Only, No Refund annuities carry the greatest risk from the owner's perspective because if the owner/annuitant dies prematurely—even after receiving only one payment—the insurance company's obligation terminates. The insurance company, in making a Life Only, No Refund annuity payment guarantee, incurs no cost for guaranteeing a survivor benefit (or refund feature). This is why the payments for a Life Only, No Refund annuity will be greater than the payments for a Life Annuity with Refund.
For Medicaid purposes, such an annuity will probably be deemed to be a divestment because it potentially can make payments beyond an owner's published Medicaid life expectancy.

B. Life With Period Certain

This settlement option is often selected because it provides a hedge against premature death as compared to a Life Only, No Refund option. In this option, the company makes payments for the longer of the owner/annuitant's lifetime or a certain period of years, such as 10, 15, 20 years. In this option, if the owner/annuitant dies before the expiration of the designated period, payments will continue for the benefit of the beneficiary for the balance of the unexpired period. Generally, the longer the period certain guarantee, the smaller each periodic payment.

For Medicaid purposes, such an annuity may also be deemed to be a divestment because it potentially can make payments beyond an owner's published Medicaid life expectancy.

C. Life Annuity, With Refund

As with other "life" settlement options, payments from a "life annuity, with refund" continue for the owner/annuitant's lifetime. If the owner/annuitant dies before receiving his/her original investment, the company will pay the rest of the unpaid original investment as a refund to the designated beneficiary.

For Medicaid purposes, such an annuity may also be deemed to be a divestment because it potentially can make payments beyond an owner's published Medicaid life expectancy.

D. Period Certain

A Period Certain option pays income for a certain period, such as 10 or 15 years. If the owner/annuitant dies during that period, payments continue to the beneficiary (or to a "contingent annuitant" if one is named). At the expiration of the period, the benefit payments terminate.

For Medicaid purposes, such annuity payout will not be a divestment if the period certain selected is less than or equal to the published Medicaid life expectancy. One problem encountered in annuitizing deferred annuities for Medicaid qualification is that many insurance companies will not cooperate in granting a period certain election which satisfies the agency's published life expectancy table.

E. Joint and Survivor Option

The joint and survivor option is an annuity that will distribute funds to two persons, typically a husband and wife for their joint lives. Should either die, the annuity continues to distribute funds to the remaining annuitant. When the second annuitant dies, the distribution of funds will cease. Any remaining funds in the annuity
account are kept by the insurance company. Some companies allow a joint and
survivor payout to include a refund feature.\textsuperscript{14}

For Medicaid purposes, such an annuity may be deemed a divestment because
payments could extend beyond either owner’s published Medicaid life expectancy.

\textbf{F. Fixed Amount Option}

In this option, the owner selects a fixed monthly, quarterly or annual amount in
order to secure a certain level of income. Cost of living increases can also be built-in.

For Medicaid purposes, if the payment period extends beyond the published
Medicaid life expectancy, a divestment will occur.

\textbf{X. TAX RULES DURING OWNER’S LIFE}

\textbf{A. Introduction}

The rules regarding taxation of annuities are intricate. The income tax rules of
annuities are set forth in IRC §72 and the applicable Treasury Regulations.

\textbf{B. Comparing the Tax Rules of Qualified and Nonqualified Plans}

Familiarity with the tax rules of IRAs and employer-provided retirement plans
(“qualified plans”), provide a firm foundation when analyzing the more obscure tax
rules of annuities. Tax incentives common for both annuities and qualified plans
reflect Congressional intent to encourage people to save for their retirement years.

Contributions to qualified plans may only be made when an owner is employed
and contributions are limited under IRS rules by an employee’s income or other
employer-based rules. By contrast, contributions to annuities are unlimited and are
available to the retired as well as the employed.\textsuperscript{15} Contributions to qualified plans are
either deductible by the individual investor or excluded from his or her income. By
contrast, contributions to annuities are neither deductible nor excludable.\textsuperscript{16}

Owners of both qualified plans and annuities are subject to early withdrawal
penalties of 10% for withdrawals made before age 591/2.\textsuperscript{17} These penalties do not apply
to disabled owners. They can also be avoided by electing annuitization or other long-
term payout strategies that are available for both qualified plans and annuities.\textsuperscript{18}

For both annuities and qualified plans, earnings on contributions are tax-
deferred.\textsuperscript{19}

The ownership of qualified plans cannot be legally transferred. The ownership of
deferred annuities can be transferred, however, which triggers a taxable event

\textsuperscript{14} Comment by John Olsen, CLU, ChFC, AEP
\textsuperscript{15} Contribution limitations to employer plans under IRC § 415 (2006) and to IRAs under IRC § 408
(2006) do not apply to NQ annuities.
\textsuperscript{16} The ability to deduct contributions is limited to IRAs under IRC § 219(b) (2006).
\textsuperscript{17} IRC § 72(q) (2006) for deferred annuities and IRC § 72(t)(2006) for qualified plans.
\textsuperscript{18} IRC § 72(q) (2006).
\textsuperscript{19} IRC § 72(e) (2006).
requiring all tax-deferred earnings to be recognized and taxed to the transferor as ordinary income.\textsuperscript{20}

All withdrawals from qualified plans are taxable as ordinary income. This is true whether the funds are plan contributions or are the product of post-contribution earnings. In contrast, withdrawals from annuities are treated differently, depending upon the funding source. Withdrawals that represent the investor’s contributions to the contract are treated as nontaxable return of capital, whereas withdrawals sourced from post-contribution earnings are taxable as ordinary income.\textsuperscript{21} The reasoning behind this disparate treatment rests on the fact that all qualified plan assets were tax-deferred, no income tax was paid by the owner on that money, and then on withdrawal day the deferral ceases and tax is realized.

Owners of qualified plans are subject to Required Minimum Distribution (RMD) rules at age 70½ (the Required Beginning Date). However, owners of annuities are not subject to age 70½ RMD rules.\textsuperscript{22} The income tax deferral of an annuity can continue after age 70½ up to the annuity contract’s “annuity starting date” (ASD). Once the ASD is reached, the annuity must be paid out; however, most insurance companies will extend the ASD upon request.

C. Deferral of Tax on Undistributed Gain

Tax-deferral on annuity investments is the most-often-cited advantage of deferred annuities. However, tax-deferral of earnings is not an automatic feature of all annuities. To receive tax-deferred status, annuities issued after January 18, 1985 must satisfy the “force-out” requirements of IRC §72(s). These provisions are discussed in more detail in Section 13. The purpose of the force-out rules is to prevent extended tax-deferral. These rules are similar to the Minimum Requirement Distribution rule for qualified plans.

D. Potential Loss of Tax-Deferred Status for Annuities Owned by Trusts

Prior to 1986, the earnings maintained within deferred annuities were tax-deferred regardless of who or what entity was designated as owner. Then, in 1986, IRC §72(u) was added to deny tax-deferred status for annuities owned by “non-natural” entities, e.g. corporations, partnerships, and certain trusts.

IRC §72 (u) provides for an exception for trust-owned annuities as long as the trust acts “as an agent for a natural person”. Revocable trusts with either a human settlor or beneficiary satisfy the “agent for a natural person” exception and, therefore, continue to enjoy tax-deferred status. Moreover, the IRS has been lenient in private letter rulings in preserving tax-deferred status for annuities owned by “irrevocable” trusts as long as human beings are named as trust beneficiaries.\textsuperscript{23}

\textsuperscript{20} IRC § 72(e)(4)(C) (2006); First Nat’l Bank of Kansas City v Com., 309 F.2d 587 (8th Cir. 1962).
\textsuperscript{21} IRC § 72(e) (2006).
\textsuperscript{22} MRD requirements are set forth in IRC §§ 408(a)(6), 408(b)(3) and 401(a)(9) (2006) which do not mention annuities.
There may be good reasons for transferring the ownership of a deferred annuity to a trust for probate guardianship avoidance, estate tax purposes or Medicaid planning. Before undertaking such a transfer, the potential tax and death benefit complications must be assessed. (See Sections 12(g), 13, and 14).

**E. Ownership Transfers Trigger Taxation**

A transfer of annuity ownership by gift may result in current income and gift tax consequences as well as potential death-time tax consequences. Transfers between spouses are excepted from income and gift tax consequences.

1. **Annuity Gifts of Post-April 22, 1987, Contracts**

   Gratuitous transfers of annuities issued after April 22, 1987, result in recognition of all tax-deferred earnings for income tax purposes as ordinary income as of the date of the transfer.\(^{24}\)

   The cash surrender value at the time of transfer may be subject to state and federal gift tax reporting requirements if the value exceeds the annual gift tax exclusion.

   The new owner of the annuity (donee) receives the donor's cost basis increased by any gift tax the donor has paid. The new owner will continue to enjoy tax-deferred growth on post-transfer earnings.

2. **Annuity Gifts of Pre-April 23, 1987, Contracts**

   If an annuity contract issued before April 23, 1987, is transferred by gift, the income tax consequences are slightly different. Instead of the accrued interest being taxable to the donor in the year of transfer, such accrued interest is taxed to the donor when the donee either surrenders the contract or the contract's maturity date arrives.\(^{25}\)

   Gifts of annuities between spouses and those made to ex-spouses incident to a divorce do not trigger recognition of gain to the donor.\(^{26}\)

   Also, the IRS has privately ruled that the ownership transfer of a trust-owned annuity to a trust's beneficiary will not trigger income tax recognition to the beneficiary.\(^{27}\)

   Unlike the transfer of highly appreciated securities to a charity, an annuity owner cannot escape the gain recognition rule by transferring ownership to a charity. It is better to liquidate the annuity and give the proceeds to the charity if surrender charges do not apply.

3. **Death-time Tax Consequences**

   If an ownership transfer results in an owner and annuitant being different persons, certain death-time tax elections and timing rules could result. (See Sections 12 and 13).

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F. Loans and Sales

Loans taken from annuity contracts trigger income tax to the owner to the extent of accrued interest. The fact that the owner has a repayment duty does nothing to vitiate the income tax consequences. 28

This same rule applies to contract assignments to secure bank or other loans.

G. Assignment of Payment Rights is a Taxable Event

Another unfortunate tax rule is that an annuity owner cannot transfer income liability by irrevocably assigning the right to receive annuity payments to another while still maintaining ownership of the annuity. 29

Example: An annuity owner receives an immediate annuity payment of $1,000 per month from an annuity. He irrevocably assigns the income to his son, who then receives the $1,000 per month. Unfortunately, the owner will be taxed on the payments his son receives.

H. Tax Deduction for Annuity Losses

Fortunately, if the market value of a variable annuity declines below the owner's investment in the contract and the owner surrenders the contract, such an investment loss is a deductible ordinary loss to the owner. 30 The loss can be claimed without audit risk as a miscellaneous itemized deduction subject to the 2% Adjusted Gross Income floor.

I. IRC § 1035 Annuity Exchanges

Under IRC §1035, “no gain or loss shall be recognized on the exchange” of a life insurance policy for an annuity or an annuity for an annuity. The new annuity acquired will receive a carryover basis equal to the dollars invested in the surrendered insurance or annuity contract.

Non-tax advantages: This tax-friendly exchange provision can help an owner exchange a low-performing or an outdated annuity contract with a better performing or more modern contract with better minimum lifetime and/or death benefit guarantees. Also, a deferred annuity can be exchanged for an immediate annuity in the same or a different company. This strategy may be needed if a deferred annuity cannot be annuitized in a desired way to comply with Medicaid rules.

As with all IRC §1035 exchanges, one must be wary of certain landmines. This is especially true of annuity replacements. Such replacements are treated as full surrenders. At the time of exchange, all surrender charges will be due. The new contract carries a new extended period of surrender charges. Often the issuing company will offer a first-year bonus to the owner to reduce the impact of the monetary loss created by surrender penalties in making the switch. However, if the

new contract is a fixed contract, the second and future years' interest will often decline
to below-market rates, thereby offsetting the purported benefit of the bonus.

These exchanges mask planning traps for seniors and those potentially in need of
long-term care. An exchange of an annuity for a new annuity with a new surrender
charge schedule can be devastating if the individual requires care in other than a
skilled nursing facility, because many of the annuity contracts contain a waiver of the
surrender charges on entry to a skilled nursing facility but not on entry to a home-care
or assisted-living situation.

Replacement annuities are subject to a high level of scrutiny with both federal
security regulators (NASD), National Association of Insurance Commissioners
(NAIC) and state regulators. Due to the increased regulatory scrutiny, many companies
have internal policies requiring their sales agents to provide specific justification and
increased disclosures to clients.

J. Tax Rules for Lifetime Payments—General

There are three scenarios under which annuity payments can be subject to
taxation. For example, assume an annuity purchaser invested $50,000 in an annuity
and it has grown over the years to $100,000 and the owner now wants to withdraw
$10,000.

```
   50,000
   
   Growth
   (taxable accrued interest)
   
   Investment in
   Contract (nontaxable return
   of capital)
   
   50,000
   
   100,000 current
   cash value
```

Interest First Rule: The entire $10,000 could come from the taxable accrued
interest.

Cost Recovery Rule: The entire $10,000 could come from the non-taxable
investment.

Pro-rata Rule: The money can be withdrawn as $5,000 from the taxable part and
$5000 from the non-taxable part. Many commentators call this payout method the
"regular annuity rule" because it is the most typical method employed.

The application of these three alternatives depends upon what kind of
distributions are taken and when the distributions start. The payment rules of IRC §72
divide payments into two categories: (1) "amounts received as an annuity," which are
annuitized periodic payments, or (2) "amounts not received as an annuity," which
include withdrawals, complete surrenders and other non-annuity payments.
All pre-mortem and post-mortem annuity payments fall into one of these two classifications.

K. Amounts Received as an Annuity

Payments made by means of an irrevocable annuitization election of a deferred annuity or immediate annuity purchase are treated as "amounts received as an annuity" and each payment is apportioned between tax-free return of investment and taxable accrued interest.\(^{31}\)

Irrevocably annuitized payments are considered as being made after the Annuity Starting Date (ASD), even if the initially designated ASD in the contract is an earlier or a later date. The contract's ASD is considered an artificial date of no real import; the pivotal feature is the irrevocable election to receive periodic payments. Excluded from income tax consideration are the portions of any annuity payments that relate to the recovery of capital. The "exclusion amount" for fixed annuities is calculated as follows:

\[
\text{Investment} \times \frac{\text{Annuity payment}}{\text{Expected return}} = \text{Exclusion Amount}
\]

The expected return is the annual amount to be paid to the annuitant multiplied by the number of years the payments will be received. The payment period may be a term certain or for the life of one or more individuals. When payments are for life, the taxpayer must use the annuity life expectancy table published by the IRS to determine the expected return. The expected return is calculated by multiplying the appropriate multiple (life expectancy) by the annual payment.

**Pro-rata Rule:** Suppose a 54-year-old person purchases a fixed annuity for $90,000, with lifetime monthly annuity payments of $500. The life expectancy of this 54-year-old person is 29.5 years from the annuity starting date. The expected return on this annuity is as follows $500 \times 12 \times 29.5 = $177,000, and the exclusion amount is $3,051 \left(\frac{$90,000 \text{ investment}}{$177,000 \text{ expected return}}\right) \times \$6,000 \text{ annual payment}\). The $3,051 is a nontaxable return of capital, and $2,949 is included in gross income.

The exclusion ratio (investment ÷ expected return) applies until the owner/annuitant has recovered his/her investment in the contract. Once the investment is recovered, the entire amount of subsequent payments is taxable.

In the case of variable annuities, the above formula for fixed annuities cannot be used because the expected return is unknown. The calculation of variable annuities can be obtained by requesting it from the issuing company.

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31. IRC § 72(b) (2006).
L. Amounts Not Received as an Annuity (Withdrawals before the Annuity Starting Date).

Before a deferred contract is annuitized, the owner may make partial withdrawals or a complete surrender. The owner may also elect to take revocable systematic withdrawals that give an appearance of annuitized periodic payments, but are not. Prior to August 14, 1982, the withdrawals were considered to have come first from the owner’s investment in the contract, known as the Cost Recovery Rule, also known as “Principal First” or First-In, First-Out (FIFO).32

In 1982, Congress changed the tax rules applicable to these withdrawals. Withdrawals equal to or less than the post-August 13, 1982, earnings must be currently included in gross income.33 This is the Interest First Rule, also known as Last-In, First-Out (LIFO). Amounts received in excess of post-August 13, 1982, earnings are treated as a recovery of capital until the taxpayer’s cost has been entirely recovered. The 1982 rules were enacted because Congress perceived that the recovery of capital rule was being abused. Previously, individuals could purchase annuity contracts that guaranteed an annual increase in cash value and withdraw the equivalent of interest on the contract but recognize no income tax. The following examples illustrate this rule change.

Cost Recovery Rule: In 1978, an investor purchased an annuity for $30,000. Four years later (on August 13, 1982) the cash value increased to $35,000. On September 1, 2006, the contract grew to $60,000 and the owner withdrew $20,000. The pre-August 14, 1982, earnings on this contract were $5,000.

Under the Cost Recovery Rule, the first $5,000 of the $20,000 withdrawal was tax-free return of capital and the additional $15,000 was taxable. The owner’s basis in the contract became $25,000 ($30,000 - $5,000).

Interest First Rule: In 2005, a 60-year-old man purchased an annuity for $30,000. Two years later, the cash value increased to $33,000, at which time the owner withdrew $4,000. The income tax recognition on this withdrawal was $3,000 ($33,000 cash value - $30,000 cost) under the Interest First Rule. The remaining $1,000 is tax free as a recovery of capital, which reduced the basis in the annuity policy.

M. Penalty for Pre-59½ Withdrawals

To encourage Americans to save for retirement, Congress granted tax deferrals for both qualified retirement plans and annuities. To discourage their use as short-term investments by younger persons, Congress enacted a 10% early withdrawal penalty for withdrawals made before age 59½.34

33. IRC § 72(e) (1) (2006).
34. IRC § 72(q) (2006).
For annuities, the penalty only applies to the amount of tax-deferred interest that would be includable as income. Not all withdrawals made before age 59 1/2 are subject to the 10% early withdrawal penalty. Withdrawals made under the following circumstances are exempt from the 10% early withdrawal penalty:

1. Death of the annuity owner (or, where the owner is not an individual, such as a trust, the death of the annuitant);
2. Disability of the annuity owner;
3. Life expectancy payout arrangement that “are part of a series of substantially equal periodic payments”;
4. Payments received under an immediate annuity payout; and
5. Funds withdrawn from pre-August 14, 1982, contributions.\(^\text{35}\)

N. Non-Tax Surrender Penalties.

All annuity contracts impose sales charges to compensate the sales agent. These charges should not be confused with the pre-59 1/2 10% early withdrawal tax penalty. Annuity contracts in which sales charges are paid up-front are known as Option A contracts. Most clients, however, elect to defer sales charges. These are known as Option B contracts. Surrender charges, also known as Contingent Deferred Sales Charges, are assessed against Option B contracts when withdrawals are made during a declining surrender period, usually between five and ten years.

The industry average is seven years, although some companies only impose a three or four year surrender period. Most companies only assess surrender charges against the remaining investment (or principal) in the contract, not against the accrued interest. Additionally, most companies waive surrender charges to the extent of 10% of the principal withdrawn within one contract year plus earned interest. Surrender charges are usually also waived when deferred annuity contracts are annuitized.

For example, assume a client invested $100,000 in an annuity that has a 7% surrender charge for the first year, which declines by 1% per year thereafter. Assume in the third contract year, the client withdraws $40,000 when the contract’s value is $120,000 (no other withdrawals were previously made). The first $20,000 of the $40,000 is exempt from surrender charges because it came from earned interest. The next $10,000 is exempt from surrender charges because 10% of principal (10% x $100,000) can be withdrawn without surrender charges in any contract year. The remaining $10,000 of withdrawn funds are subject to a 5% surrender charge of $500. Most (but not all) companies waive surrender charges upon the owner’s death or admission to a skilled nursing home for at least 90 days. Some companies waive the penalty upon the owner’s permanent disability.

To properly assess the status of surrender charges, both the client’s annuity contract and account statements for each year must be reviewed. Thereafter, the surrender charge status should be reviewed with the client’s investment advisor if available, or the company’s home office. From a tax perspective it is notable that product-based surrender charges are not tax-deductible.

\(^{35}\) Id.
XI. DEATH OF OWNER OR ANNUITANT – GENERAL

The death of the owner or the annuitant results in the following tax and non-tax considerations, which are addressed in the following sections:

• Income Taxation of Annuity Death Benefits.  
  Section 12
• Whose Death Ends the Contract?  
  Section 13
• Determining the Amount of the Available Death Benefit.  
  Section 14
• How Joint Ownership Designations Affect Death Benefits.  
  Section 15
• How Designating a Trust as Beneficiary Affects Tax Elections.  
  Section 16
• Estate Tax Treatment of Annuities.  
  Section 17

XII. INCOME TAXATION OF ANNUITY DEATH BENEFITS

A. Introduction

Annuity death benefits do not qualify for the life insurance proceeds exemption from income taxation under IRC §101 (c).36 It is the beneficiary receiving the death proceeds, rather than the decedent, who is subject to income taxation on the gain as ordinary income.37 The taxable portion of the death benefit is treated as Income with Respect to a Decedent (IRD) under IRC §691.38 IRD from an annuity death benefit is generally not entitled to a stepped-up tax basis under IRC §1014.39 There is a very limited exception for certain variable annuity contracts purchased prior to Oct 21, 1979.40

The taxable amount to the beneficiary is the amount received less the decedent’s tax basis in the contract.41 The amount equal to the decedent’s tax basis is received by the beneficiary as tax-free under cost recovery principles.42 The amount of taxable income to the beneficiary will often be more than the amount of accrued interest in the contract at the time of the decedent’s death. This is because the actual amount received by the beneficiary will often be greater than the account balance at the time of the owner’s death. The presence of a guaranteed death benefit which will cause the death benefit to be greater than the death-time account balance is one reason for this. (See Section 14). A second reason for the increase is that the annuity may grow in value between the time of the owner’s death and the time the insurance company issues the check to the beneficiary.

The foregoing income tax rules for annuity death payouts are only the simplistic beginning rules. A few comparisons are next discussed. Thereafter, more specific tax rules concerning distribution options and their timing rules are addressed.

37. Id.
39. Id.
40. Id.
41. Id.
42. Id.
B. Comparing Death-Time Payout Tax Rules of Annuity and Qualified Retirement Plans

The death-time tax elections for beneficiaries of annuities are found in IRC §72(s) and IRC §72(h). Post-death distribution tax rules for annuities, although similar, are different in several aspects from the post-death distribution tax rules for qualified plans found in IRC §401(a) (9) and its regulations.

The tax distinctions made for post-death distributions depending on whether a qualified retirement plan owner dies before or after attaining the Required Beginning Date of 70½ does not apply to annuity beneficiary distributions after the annuity owner dies.

The stretch-out over life expectancy opportunity for beneficiaries of deceased qualified plan owners under IRC §401(a) (9) and its regulations are limited for annuity beneficiaries. Additionally, the favorable stretch-out over life expectancy of the eldest trust beneficiary available under IRC §401(a) (9) for qualified plans is not available for annuities.

C. Color-Coded Comparative Analysis of Death-Time Payout Tax Rules According to Asset Groups

An easy way to begin to grasp the death-time income tax rules of annuities is a color-coded comparative analysis as follows:

1. **Red Money** – pre-tax qualified plans are 100% taxable as ordinary income when distributed at death. They receive no stepped-up tax basis under IRC §1014.

2. **Green Money** – after-tax assets, e.g. land, stocks, bonds, mutual funds, personal property generally receive an IRC §1014 stepped-up tax basis.

3. **Yellow Money** – partially after-tax assets, e.g. annuities and U.S. Bonds, receive no stepped-up tax basis and are tax-free to the extent of investment in the contract but are taxable to the extent of accrued interest as ordinary income.

4. **Gold Money** – after-tax Roth IRAs and post-death earnings, if any, are tax-free to the beneficiary.

Green money is better than Red or Yellow Money. Yellow Money is better than Red Money. But Gold Money is best.

D. Tax Rule for Annuity Death Benefits Already in Payout Status

Death benefits of an immediate annuity purchased before the death of the decedent or a deferred annuity annuitized before the death of the decedent are governed by IRC §72(s)(1)(A) which provides, in part:

The remaining account balance of the annuity will be distributed “at least as rapidly as under the method of distributions being used as of the date of his/her [the owner or annuitant’s] death.”

IRC §72(s)(1)(A)’s “at least as rapidly” rule has an exception in IRC §72(s) (2) which allows for a longer payout not to exceed the “life of the designated beneficiary”
if the payout begins “not later than one year after the date of the holder’s [owner’s] death. . .”

For example, if an owner of an immediate annuity was taking a period certain fixed annual payment of $10,000 for 10 years, and died in the fifth year after receiving five payments, then the beneficiary will receive the remaining five payments or, if permitted by the contract, could receive a lump sum commuted value. Either option would qualify under the “at least as rapidly” rule of IRC §72(s) (1) (A). Additionally, if permitted by the contract, the beneficiary could elect a lifetime payout under IRC §72(s) (2) if payments commence within one year of the decedent’s death.

If the beneficiary elects an annual periodic payment, the beneficiary is entitled to use the more favorable Cost Recovery Rule, thereby excluding, for tax purposes, the decedent’s remaining investment in the contract first. The beneficiary then will be taxed on the accrued interest as received.43

If a lump sum is permitted by the contract and is taken, then the beneficiary will be taxed on all the accrued interest in the year of receipt.44

E. Annuities not in Payout Status When a Spouse is Beneficiary

When a spouse of the contract owner is named as the primary beneficiary of a deferred annuity (not in payout status) and the owner-spouse dies, IRC §72(s) provides the surviving spouse with the following options, subject to the parameters of the contract:

1. Receive a lump sum;
2. Spousal Continuation. This means the surviving spouse will step in to the shoes of the owner, and the contract will continue. Since the spouse will not take rights as a beneficiary, the spouse may lose the minimum guaranteed death benefit under some contracts. Some companies allow a surviving spouse to receive a guaranteed death benefit and elect spousal continuation. In an IRA spousal rollover, the surviving spouse may switch companies with a special rollover election. For surviving spouses electing continuation of an annuity contract, switching companies can be achieved through an IRC §1035 exchange. (See Section 10 (i));
3. Five-Year Rule. Defer payments over five years following the owner’s death; or
4. Annuity payout over life expectancy.

If the surviving spouse elects an annuity payout over life expectancy, this option must be timely elected. (See discussion below in 13(g)). These periodic annuity payments will be taxed under the pro-rata (regular annuity) rule of IRC §72(b) (1).

F. Annuities not in Payout Status to Beneficiary Other Than a Spouse

IRC §72(s) provides a non-spouse primary beneficiary of a deferred annuity with the following options, subject to the parameters of the annuity contract:

43. IRC §72 (e)(5) (2006); Treas. Regs. §§ 1.72-11(a), 1.72-11(c) (2006).
1. Receive a lump sum;
2. Defer payments over five years; or
3. Receive annuity payout over life expectancy or a period certain.
   According to an IRS Private Letter Ruling, a beneficiary of an annuity
   was allowed to elect a "stretch annuity," which mimics Required
   Minimum Distributions for IRAs.²⁵ Only a few insurance companies,
   however, permit such an arrangement.

The annuity payout option over life expectancy must be timely elected (see
discussion below) and will be taxed according to the pro-rata rule (regular annuity
rule) of IRC §72(b)(1).

G. Tax Code Time Limits for Electing Extended Annuity Payouts

If a beneficiary of a deferred annuity wants to elect an annuity payout of more
than five years, he/she must accomplish it in a timely manner. What is "timely" is
confusing under two conflicting provisions of the Internal Revenue Code for which the
IRS has not provided any guidance. IRC §72(s)(2)(C) requires that an annuity payout
of more than five years "begin not later than one year after the date of the holder's
[owner's] death." This implies, but does not expressly state, that a designated
beneficiary may elect such an extended payout election not later than one year after the
owner's death.

IRC §72(h), which was enacted 20 years earlier, on the other hand, requires that
an election to take a non-lump sum extended payout be "exercised within 60 days after
the date on which such lump sum [an alternative option] first became payable." A key
difference between these two subsections of IRC §72 is that the IRC §72(s)(2)(C)
specifically applies to annuity death benefits whereas IRC §72(h) does not. It is
apparent that the principal intent of §72(h) was to soften the "constructive receipt"
doctrine in a line of cases²⁶ concerning the receipt of lifetime annuity payments rather
than death benefits. Rather than requiring the immediate taxation when an annuity
owner's right to receive an annuity lump sum becomes payable, IRC §72(h) gives the
owner 60 days within which to elect an extended payout arrangement. The specificity
of IRC §72(s)(2)(C)'s application to death benefits and IRC §72(h)'s lack thereof
suggests that the 60-day rule of IRC §72(h) may not apply to annuity death benefits.
This is a weak argument because if Congress had intended such a construction it
would have amended IRC §72(h) at the same time it added IRC §72(s)(2)(C). It is
safer to assume that IRC §72(h) applies to both the lifetime rights of the owner and the
rights of beneficiaries after the owner dies.

Theoretically, the payable date of an annuity lump-sum death benefit is the date of
the decedent's death. Under the "constructive receipt" doctrine, the full death
benefit would then immediately become taxable to the beneficiary. However, from a
practical standpoint, very few annuity beneficiaries, who typically are unaware of their

²⁵ IRS PLRs 200151038, 200313016 (2006).
²⁶ Henry Snyder, Est. (1959) 31 TC 1064, not acq. 1963-2 CB6; Blum v Higgins (1945 CA2) 34
AFTR 24, 150 F2d 471, 45-2 USTC § 9343; Kappel v U.S. (1974, DC PA) 34 AFTR2d 74-5025,
369 F Supp. 267, 74-1 USTC § 9419.
rights when the owner dies, could notify the annuity company within 60 days after the owner’s death of their intent to take a non-lump sum extended payout. Also, a lump-sum payout could not actually be “payable” as IRC §72(h) requires, until the annuity company is aware of the owner’s death. Therefore, it is conceivable that Congress intended that IRC §72(h)’s 60-day limit start, not on the date of the owner’s death, but rather when the annuity company is notified of the owner’s death. For this reason, it is advisable to refrain from notifying the annuity company of the owner’s death until the beneficiary’s options and goals are determined.

Another difference between IRC §72(s)(2)(C) and IRC §72(h) is that IRC §72(h) specifically addresses the timing of the taxation of annuity death benefits whereas IRC §72(s)(2)(C) does not. Under the literal language of IRC §72(h), a beneficiary who fails to make a timely election for an extended payout within 60 days of the decedent’s death, must recognize all the gain in the year of death, even if the beneficiary does not actually receive any funds in the year of the decedent’s death. Such a harsh result suggests that every attempt be made to make an extended payout election within 60 days after the owner’s death.

An annuity contract, or the insurance company issuing the contract by an internal policy, may choose to disregard IRC §72(h)’s harsh 60-day rule and allow a beneficiary to elect within one year of death a non-lump sum extended payout. But there is no guarantee that the IRS will accept such a position.

A tax trap exists for annuitant-driven annuities for which only the 60-day limit applies, the one-year rule being foreclosed. See further discussion in Section 13.

Therefore, the better approach is not to rely on the one-year rule, but rather, to presume that the 60-day rule applies and make a payout election within 60 days after death. As a practice point, it is important for the Elder Law Attorney to consult with the beneficiaries soon after the annuity owner’s death to determine whether a beneficiary may benefit from an annuity payout of greater than five years. However, if 60 days have passed after the decedent’s death and an extended payout election has not been made, but is desired, an extended election should still be made. If the untimely election is rejected by the insurance company, the beneficiary should argue that the one-year rule is the correct rule. If there are less than 60 days left after notifying the company of the owner’s death, the beneficiary should argue that the 60-day rule only applies after the company has received a death notice.

\footnote{The 60-day limit under IRC § 72(h) (2006) is general in nature, applying to both annuitant and owner-driven contracts. IRC § 72(h) (2006) applies when a lump sum is “payable”. It doesn’t mention upon which party’s death the 60-day limit applies. IRC § 72(s)(2)(C) (2006), which provides for the one-year rule, is specifically triggered upon “the holder’s [owner’s] death”. It is not triggered upon the annuitant’s death. The one-year limit only applies to owner-driven contracts, and not to annuitant-driven contracts. Therefore, when the contract is owner-driven, both the 60-day and the one-year limit could apply; but when the contract is annuitant-driven, then only IRC § 72(h)’s 60-day limit is applicable as well as the harsh “constructive receipt” taxation rule.}
XIII. **Whose Death Ends the Contract?—Comparing Annuity vs. Owner-Driven Contracts**

The death of the owner or annuitant of the contract is not the only determining factor that triggers payment of the contract’s death benefit and thereby marks the contract’s end. The contract’s end also depends upon whether the contract is owner-driven (the normal situation) or annuitant-driven (the unusual situation). (See Section 8(d) for further discussion).

The force-out provisions of IRC §72(s) (1), effective January 18, 1985, provide, among other things, that all annuity contracts issued after that date must require that the distributions to beneficiaries begin when the owner (holder) dies (not the annuitant), regardless of whether death occurs before or after the ASD, and regardless of whether the insurance company issued the contract as owner-driven or annuitant-driven. IRC §72(s) (1)’s force-out rules, triggered by the owner’s death, put an end to the contract and an end to tax-deferral. Before the force-out rules were enacted, long-term tax-deferral was possible upon an older annuity purchaser’s death, when that purchaser named a child or grandchild as the annuitant of an annuitant-driven contract. This is no longer possible. As a result of the force-out rules, most companies have only issued owner-driven contracts after January 18, 1985. Even if a company issues an annuitant-driven contract after January 18, 1985, the owner’s death or the annuitant’s death (whichever occurs first) will trigger the contract’s end. The one-year rule of IRC § 72(s)(2)(C) and the 60-day rule of IRC § 72(h) were discussed above in Section 12 (g). It was pointed out that both timing rules can apply to owner-driven contracts, but the 60-day harsher limit only applies to annuitant-driven contracts. The following examples will help the reader understand these complicated rules.

**Example 1: Owner-Driven Contract.**

In an owner-driven contract, the death benefit is triggered upon the death of the owner, not the annuitant. For example, an annuity is purchased from a company after January 18, 1985, which characterizes the annuity as being owner-driven, and the owner names herself as owner, and the annuitant as herself as owner, and another child as beneficiary. If the owner dies, a death benefit will be triggered and the beneficiary will receive the death proceeds. The one-year or the 60-day timing rule could apply here.

If, on the other hand, the annuitant dies, no death benefit is triggered, and the owner will have the ability to name a new annuitant following the death of the annuitant. The owner should notify the company of the death of the annuitant.

**Example 2: Annuitant-Driven Contract Issued Before January 18, 1985.**

In an annuitant-driven contract issued before January 18, 1985, the death of the annuitant, not the death of the owner, will trigger the payment of a death benefit. For example, on January 1, 1980 (before January 18, 1985), an annuity is purchased from a company that characterizes the annuity as being “annuitant-driven.” The annuity

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48. There is an issue in IRC § 72(s)(1) (2006)’s use of the term “holder” rather than the insurance industry’s term, “owner.” This is because its force-out provisions are triggered upon the death of the annuity “holder.” Unfortunately, the tax code does not define “holder”. However, a close reading of IRC § 72(s)(4) (2006) and IRC § 72(s)(6) (2006) reveals that the term “holder” must mean “owner.”
purchaser names herself/himself as annuitant, a child as owner, and another child as beneficiary. If the annuitant dies first, the death benefit will be triggered for the beneficiary’s benefit. The one-year timing rule will not be available; rather, the 60-day rule will apply. If the owner dies first, the death benefit will not be triggered, in which event the annuitant automatically becomes the new owner pursuant to contract terms.

**Example 3: Annuitant-Driven Contract Issued After January 18, 1985.**

On February 1, 2000 (after January 18, 1985), an annuitant-driven contract is purchased and the owner names herself/himself as owner and annuitant, and names a child as beneficiary. Later, the owner transfers ownership of the contract to another child. If the annuitant dies first, the death benefit is triggered because the contract is annuitant-driven. As in Example 2, the one-year timing rule will not be available; rather, the 60-day rule will apply.

But what if the owner-child dies before the annuitant-parent? The result is the same. The force-out provisions of IRC §72(s)(1) will trigger a death benefit upon the owner’s death. In this case, the 60-day rule and the one-year rule may apply.

**Example 4: Trust-Owned Annuity Becomes Annuitant-Driven.**

The required payout of the death benefit upon the annuity owner’s death under IRC §72(s)(1) assumes the owner is a human being. When a trust is an owner of an annuity, the application of this rule becomes problematic because a trust cannot die. IRC §72(s)(6)(B) solves this problem by providing that:

“If the holder [owner] of the contract is not an individual [e.g. a trust], the primary annuitant shall be treated as the holder [owner] of the contract.”

As was pointed out earlier in Section 5, an annuitant is always a human being. IRC §72(s)(6)(B) means that when an annuity is owned by a trust, the force-out rule of IRC §72(s)(1) is triggered upon the death of the annuitant. This contract would then be considered as annuitant-driven. This rule should be considered when an annuity purchaser names a trust as owner or when an individual owner later transfers ownership to a trust.

**Example 5: Planning Strategy to Achieve Extended Tax Deferral After Death of the Annuity Purchaser.**

The force-out rules can be avoided, allowing for extended tax-deferral, if an older owner/annuitant transfers ownership of an annuity to a child or other younger loved one. If the aging purchaser, who is now only the annuitant, dies and the younger new owner survives, the contract continues and the new owner also becomes the new annuitant. Not only are the force-out rules avoided, but so are the post-death timing restrictions of IRC §72(s) (2) (C) and IRC §72(h). (See Section 12(g)).

**XIV. Determining the Amount of the Available Death Benefit**

For real property, personal property, retirement plans, bank/credit union assets, bonds and securities, the post-death value available to beneficiary will be equal to the decedent’s pre-death fair market value. For annuities, the presence of guaranteed death benefits may allow the death benefit to be greater than the pre-death account value. Such a death benefit will be at least equal to the adjusted cost basis (the owner’s premiums paid less premiums withdrawn) even though the contract’s account balance
at death might be lower. If the contract’s account balance at the time of death is greater than the adjusted cost basis, the death benefit will be the greater account balance. Moreover, many modern variable contracts provide an enhanced death benefit that can guarantee an even greater death benefit. An example of an enhanced death benefit is a guarantee to pay the highest value of:

1. Adjusted cost basis;
2. Account value at death;
3. The highest account value as of certain prior dates; or
4. A theoretical minimum interest rate return, e.g. 5%, on the investment in the contract.

When the guaranteed death benefit can be lost or diminished. For some contracts, the guaranteed death benefit may be lost or diminished under these circumstances:

1. Withdrawals by the owner that cause negative market adjustments;
2. When the ownership of a contract is transferred;
3. When the owner and annuitant are different individuals;
4. When a spouse elects spousal continuation rather than taking a death benefit (although some newer contracts allow a surviving spouse to receive the guaranteed death benefit and elect continuation);
5. When a trust is named owner of the contract; and
6. When a deferred contract is annuitized.

At the time of purchasing an annuity contract, the purchaser should ascertain when the minimum death benefit can be lost and request a full disclosure of this feature from the financial advisor.

When an owner dies, the Elder Law Attorney can assist by reading the annuity contract and the prospectus to make sure the company has correctly calculated the death benefit.

XIV. HOW JOINT OWNERSHIP DESIGNATIONS AFFECT DEATH BENEFITS

Joint Ownership. Many insurance companies allow more than one person to jointly own an annuity. Married couples often name themselves as joint owners. The primary problem with any jointly owned annuity is the application of the force-out rule of §72(s)(1), which requires the contract to end and the death benefit to be paid out when “the holder [owner] dies. IRC §72(s)(1) does not contain an exception to this rule when two owners are named, one owner dies and the other survives. This rule is contrary to the normal state-law rule of survivorship between multiple owners of other assets (such as real estate, stocks and bank accounts) when ownership is designated “joint owners with rights of survivorship.”

An annuity contract could offer one of two different results for contracts owned by married couples when one spouse dies:

1. The surviving-spouse owner is deemed to be the primary beneficiary and the designated beneficiary is deemed to be the contingent beneficiary. In such a case, the spouse may elect “spousal continuation” under IRC
§72(s)(3). Spousal continuation is an exception to the force-out rule of IRC §72(s)(1); or
2. The death benefit is paid to the designated beneficiary rather than to the surviving spouse. In such a case, the surviving spouse's rights would end. This may result in the unintended disinheritance of the surviving spouse.

If a married couple has been named as joint owners of an annuity contract, the Elder Law Attorney can determine from the investment representative, the home office, or the terms of the contract what rights the surviving-spouse joint owner has when the first owner-spouse dies. If a married couple wants the spousal continuation advantage in a deferred annuity, the safer approach is to name one spouse as owner and the other spouse as primary beneficiary.

In some states, there may have been Medicaid planning opportunities with joint-ownership designations if the state's annuity rules exempted an annuity payout to a Community Spouse from the requirement to name the state as a beneficiary. This would have been the case if the insurance company allowed an annuity payout election for a period-certain to the Community Spouse when the other spouse is institutionalized. However, a December 2006 technical correction to the DRA requires that annuities making annuitized payments to the Community Spouse name the state as beneficiary in order to reimburse the state for Medicaid payments for the other spouse.49

When non-spouses are named as joint-owners, the spousal continuation exception to the force-out rule would not be available. Therefore, the existence of a joint owner would not prevent a forced death benefit. It is for this reason that joint ownership annuity designations for non-married couples is not recommended.

XVI. HOW DESIGNATING A TRUST AS PRIMARY BENEFICIARY AFFECTS TAX ELECTIONS

The “look-through” advantage for trusts as beneficiaries of qualified plans under Treas. Reg. §1.401(a)(9)-4.A-5 does not apply to IRC §72 annuities. Moreover, when a trust is named as beneficiary of an annuity, the following tax-advantaged payout options, available only to individual’s beneficiaries, will be lost:
1. Spousal continuation; and
2. Ability to elect an annuity payout over life expectancy.

Finally, some companies will even deny the five-year deferral option allowed by IRC §72(s) for trust beneficiaries.

On the other hand, naming a trust as beneficiary has these advantages:
1. Spousal continuation may not be desired because of a second marriage or a spendthrift or disabled spouse;
2. An annuity payout over life expectancy option may not be desired because of the existence of little taxable accrued interest;

3. Often the flexibility and protective provision of a trust are more important than any income tax savings available from an annuity stretch; and

4. Naming a trust as beneficiary for minors avoids probate conservatorship.

For example, when an owner wants a minor child or grandchild to receive an annuity, naming the minor directly will likely necessitate court proceedings so that the funds can be managed and accessed for the minor beneficiary. A trust as beneficiary would be a better option.

Before naming a living trust as a primary beneficiary or as a contingent beneficiary, all desired outcomes and tax consequences must be assessed. Clients should understand that beneficiary designation for annuities, as with life insurance and qualified plans, is a controlling testamentary disposition that should be reviewed with the financial planner and the Elder Law Attorney. Written confirmation of the accepted beneficiary designation should be part of the client’s and attorney’s permanent records.

XVII. ESTATE TAX TREATMENT OF ANNUITIES

A. Deferred annuities

The value of an annuity death benefit of a deferred annuity is includable in the federal gross estate. To the extent that it is paid exclusively to a citizen surviving spouse, the death benefit will qualify for the estate tax marital deduction.

B. Annuities in Payout Status

If a deceased owner was receiving a Life Only, No Refund annuity, the annuity terminates upon death. As a result, there is no estate tax inclusion. However, if the annuitized payments received by the deceased owner have a refund or a survivorship feature then the annuity’s present value is included in the estate tax base.

C. A Life Insurance Strategy

For taxable estates that include a large deferred annuity, a worthwhile strategy for consideration is to annuitize the annuity without a refund and use all or a portion of the payments to purchase life insurance that will be owed by an irrevocable life insurance trust (ILIT). Then the annuitized annuity will no longer be subject to estate tax. The life insurance owned by the ILIT, if properly set up, will be income and estate tax free. The annuity owner must, of course, be healthy enough to qualify for life insurance.

D. Beneficiary’s Income Tax Deduction for Federal Estate Tax

Not only is the accrued interest in an annuity subject to income tax as IRD to the designated beneficiary, but the entire annuity balance may be includable in the taxable estate of the deceased owner for estate tax purposes.

The impact of double taxation is reduced by an income tax deduction available to the beneficiary under IRC §691(c). The deduction is based on the amount of estate tax

allocable to the taxable accrued interest, and can only be taken when accrued taxable interest is received by the beneficiary.

XVIII. ADDITIONAL ESTATE AND RETIREMENT PLANNING WITH ANNUITIES

A. Avoidance of Probate

The use of beneficiary designations for annuities incorporating primary and contingent designations should avoid the need to probate annuities upon death of the owner.

If the owner of an annuity requires a probate proceeding due to incapacity, the annuity may be subject to lifetime court oversight. A well-drafted financial durable power of attorney specifically granting annuity powers should avoid this need.

B. Using an Immediate Annuity By QTIP Trust or Credit Shelter Trust

After assets are allocated between a QTIP Trust and a Credit Shelter Trust with a surviving spouse as primary beneficiary, the Trustee must decide how best to secure sufficient income for the surviving spouse as primary beneficiary of both trusts. The competing interests of remainder beneficiaries must also be considered. A possible solution may be for the Trustee to use a portion of principal to purchase an immediate annuity for the spouse with a refund back to the trust. The remaining principal can be invested solely for growth. This strategy will simplify trust administration.

C. Guaranteeing a Client’s Income Needs

Many senior citizens need income in excess of their pensions, Social Security and investment earnings. Often, their primary concern is not how to maximize a legacy, but rather how they can live a good life for as long as they live. They often are afraid of outliving their assets.

These goals can be reached by the purchase of (1) an immediate annuity or (2) a variable deferred annuity with guaranteed minimum benefits and/or guaranteed payment benefits.

D. Providing Heirs with Guaranteed Income

Often a client’s goal for heirs is to provide a lifetime guaranteed income rather than a lump sum distribution.

To achieve such a goal, a client can purchase a deferred annuity and select a “control payout” death benefit in the form of an immediate annuity over a period certain or for life expectancy. During the client’s lifetime, the client can withdraw funds as needed.

A client with a trust can accomplish the same strategy by directing a successor trustee to purchase immediate annuities for the trust beneficiaries. Such payouts can minimize overspending by beneficiaries and losses as a result of marital problems. Also, immediate annuities enjoy creditor protection in most states.
A. Impact of DRA 2005

When undertaking long-term care planning, deferred annuities present unique challenges because of the potential presence of accrued interest and surrender charges. In certain states, the unique ability to annuitize deferred annuities into an income stream did offer an advantage over other asset-types for Medicaid purposes under OBRA '93. The annuity rules of DRA as interpreted by the Center for Medicare and Medicaid and state agencies are not as favorable as those described in OBRA '93. It is disappointing to see how the DRA may frustrate Congressional tax incentives for deferred annuities and qualified plans when owners are forced to liquidate them in large chunks as a result of unexpected long-term care expenses.

B. Assessing Product Surrender Charges and Accrued Interest

Before long-term care planning can be undertaken with deferred annuities, an Elder Law Attorney must assess the applicable product-based surrender charges and the tax consequences of deferred earned interest.

In assessing Medicaid spend-down strategies, pre-paying income tax accrued inside a deferred annuity is a highly favored option. Electing a partial surrender equal to the amount of the accrued interest can do this. The tax on the interest that has been accrued in an annuity will have to eventually be paid by the Medicaid applicant, his or her spouse, or other designated beneficiaries. The net after-tax funds received can then be used to fund the cost of care or exempt purchases.

To the extent that additional funds are needed to pay for care, or exempt purchases, an increased partial or full surrender is needed. However, any applicable surrender charges must be assessed. Fortunately, most insurance companies will waive surrender charges after confinement in a nursing home for at least 90 days. The 90-day waiting period is often too long when cash is needed right away to pay the cost of care or to make exempt purchases. Advocacy may be required to petition the insurance industry to waive surrender charges for ALF placements, when Medicaid-funded home care is preferred, and when the disabled owner cannot perform two out of five Activities of Daily Living (ADLs).

C. Transferring Annuities for Medicaid Planning

The gratuitous transfer of the ownership of deferred annuities to someone other than a spouse when the transfer rules of DRA are effective on a state-by-state basis will be subject to both DRA's 60-month look-back period and its less favorable determination of penalty period start dates. Therefore, gifts of such annuities for crisis Medicaid planning should be carefully considered.

D. Annuitzation Strategies Offer Promise and Risks

Before DRA, annuitization strategies with commercial annuities worked well in some states, but not in others. DRA requires that the state must be named as a remainder beneficiary in most cases. However, a married Medicaid recipient who is
receiving annuity payments on an actuarially sound basis may name his/her spouse as the primary beneficiary but must name the state as contingent beneficiary. After DRA, some states may take the position that annuitized annuity contracts are countable resources with marketable value. The use of post-DRA Medicaid annuities will be determined on a state-by-state basis.

There may be a benefit under DRA in using a portion of excess assets to purchase short-term annuities in connection with gifting the remaining excess assets to begin the start of a penalty period as long as the applicant has become eligible for Medicaid and "would otherwise be receiving an institutional level of care."\(^5\)

XX. THE WISDOM OF ANNUITIES FOR SENIORS

Whether annuities are the appropriate investment vehicle for seniors will depend on a number of variables. Almost all of the annuity advantages listed below assume that a senior annuity purchaser has sufficient health and longevity to capture the advantages. The advantages are nearly useless for clients with chronic health or evident long-term care risks where a surrender of the annuity is likely to occur in the future.

The advantages of annuities for seniors include:

a. The out-living of assets can be prevented by using an annuitization method.

b. Fixed annuities provide freedom from market risk.

c. Tax-deferral of earnings captures compounded growth.

d. Tax-deferral can reduce taxation of Social Security benefits.

e. Owners have substantial control to decide when to incur tax on deferred annuity interest even after age 70½ since annuities have no required minimum distribution rules.

f. Variable and indexed annuities offer the chance to participate in higher market returns (or losses).

g. Annuities can offer advantages over Certificates of Deposit (CDs). Interest earnings from annuities are often higher than from CDs. Keep in mind that CDs also have early withdrawal penalties and they do not allow any penalty-free partial withdrawals. Most annuities, on the other hand, offer penalty-free 10% annual withdrawals. However, a drawback for annuities is that the typical surrender penalties for them come from principal and are therefore more substantial than the typical penalties from CDs, which come from interest. While CDs offered by banks are FDIC-insured, the reserve requirements for insurance companies offering annuities provide similar investment protection.

h. Variable annuities can offer guaranteed income, accumulation and withdrawal benefits during the owner's lifetime.

i. Annuities provide the ability to offer guaranteed death benefits.

j. Annuities provide the ability to transfer ownership, unlike IRAs.

2007] Estate Planning With Nonqualified Annuities

k. Variable annuities can provide for dollar-cost averaging, tax-free internal transfers and automatic rebalancing.
l. There is flexibility in electing settlement options during the owner’s lifetime.
m. There is flexibility in designing control-payouts after the owner’s death and some flexibility in tax-minimized death-benefit elections.
n. Annuities may offer some Medicaid qualification benefits.

However, there are disadvantages:
a. They are complicated.
b. There is substantial variation among products.
c. Consumer protection laws are fairly weak.
d. Variable annuities can present market risk, although such risk can be eliminated with special lifetime and death-time guarantees.
e. The charges and expenses are greater than for other investments.
f. The surrender charges are substantial and often inflexible.
g. Withdrawn earnings are taxed as ordinary income.
h. There is no stepped-up basis for annuities upon death of the owner.
i. Mutual funds also offer dollar-cost averaging and auto-rebalancing; however, the taxation within mutual funds is complicated in comparison with annuities, which have no tax reporting during the deferral stage.
j. Dividends and capital gains from stocks and mutual funds are subject to a flat 15% tax, whereas taxable annuity income is treated as ordinary income.
k. Death benefit tax minimization strategies available to retirement plans are not as available to annuity death benefits.

In summary, annuities can offer senior citizens some clear advantages as well as disadvantages. Investment advisors have a duty to disclose the disadvantages as well as the advantages.

XXI. GUIDING YOUR CLIENT AND ADVOCACY

Annuities are complicated and comprised of many different moving parts. The Elder Law Attorney can help a client understand his/her rights and the rights of his/her beneficiaries by consulting with the investment representative or the company’s home office. The company has a duty to explain what the contractual terms of the policy mean. Using the questionnaire such as the sample provided in the appendix hereto may be helpful. However, for compliance reasons the investment representative may not be able to fill out such a questionnaire, in which case the attorney or client can fill it out while consulting with the representative.

A recent New York Times article,12 published on July 8, 2007, reports on how elderly clients are being pushed into annuity purchases by slick investment advisor titles:

...tens of thousands of financial advisors working hand-in-hand with insurance companies to market themselves to older Americans using impressive-sounding credentials like 'certified elder planning specialist', 'registered financial gerontologist', 'certified retirement financial advisor', and 'certified senior advisor'. Many of these titles can be earned in just a few days from a for-profit business, and sound similar to established credentials, like Certified Financial Planner (CFP), which requires years of study, difficult tests and extensive background checks.

The good news is that government regulators are taking notice and action. Almost all state insurance commissions or state legislatures,\(^53\) have adopted some version of the minimal protections of the National Association of Insurance Commissioners (NAIC) Suitability in Annuity Transactions Model Regulation. This Model Regulation applies to both fixed and variable annuities. The NAIC’s Suitability Model Regulation loosely requires the annuity salesperson to determine whether an annuity is “suitable” for a particular investor. The Model Regulation’s “suitability” only entails an analysis of the purchaser’s “financial status,” “tax status” and “investment objectives,” not at the time the agent makes a recommendation to the prospective purchaser, but rather at a later time when the contract is executed. In addition, the insurance agent’s duty to perform a “suitability” analysis is waived under the Model Regulation if the consumer does not affirmatively disclose his or her personal circumstances to the agent. NAELA attorney and annuity expert Howard Berk of Chicago, Illinois, recommends that a proper “suitability” analysis should also include:

- The purchaser’s ability to pay for the proposed annuity without liquidating assets;
- The purchaser’s goals and needs and the advantages and disadvantages of investing in this particular annuity;
- The value, benefits and costs of existing investments when compared with the values, benefits and costs of the proposed annuity purchase;
- When an annuity is replaced, whether the replacement is necessary and appropriate;
- The need to have funds readily available for major expenses, including emergency expenses that may arise from time to time in daily life; and
- The annuity’s potential impact on eligibility for government benefits.

The author recommends the addition of the following to a required “suitability” analysis: “Whether the purchaser has a diagnosed health condition which may lead to catastrophic health and/or long-term care expenses during the annuity’s surrender period.”

Attorney Berk further complains that the NAIC Model Regulation on “suitability” is “superficial in coverage and illusory in its protections for consumers in that it prohibits private causes of actions if an agent fails to comply with its standards. As a result, agents and insurers are insulated from liability.”

With Mr. Berk’s comments in mind, it is not surprising that several states also impose additional hoops an annuity salesperson has to jump through when recommending an exchange of a new annuity for an existing annuity or life insurance

\(^{53}\) Michigan Compiled Law 500.4155 (Public Act 399, 2006).
policy. Agents are required to document "suitability" on special forms, especially when a replacement is involved. Some states, such as California, impose additional consumer protection measures, such as a special warning when a replacement is proposed and administrative penalties of at least $1,000 for violations. Arizona requires a standard disclosure form and a buyer's guide to allow consumers to better understand annuity proposals. 

State statutes or regulations also authorize consumer complaints for deceptive and misleading sales and advertising in the sale of annuities. In this connection, the Medicaid annuity rules of the DRA are being interpreted by states as requiring both actuarial soundness and state-as-remainder beneficiary. Before DRA, when actuarial soundness was the only Medicaid requirement, sales pitches for "Medicaid-friendly" deferred annuities that could pass actuarial soundness muster had some justification. After DRA, actuarially sound annuities that will be recovered by the state have very little justification. Therefore, such sales pitches can be classified as deceptive and misleading advertising under each state's insurance law or regulations.

With specific regard to variable annuities that are funded with securities, the National Association of Security Dealers (NASD) is authorized under the federal statute establishing the Securities and Exchange Commission (SEC) to propose rules on variable annuities and to investigate consumer complaints. NASD's Rule 2310 provides suitability standards for variable annuities similar to NAIC's suitability rule which can apply to both fixed and variable annuities.

On May 15, 2007, NASD announced a new proposed rule to further strengthen Rule 2310. Moreover, the SEC has taken action of its own in calling a Seniors Summit on September 10, 2007, in Washington, D.C. to coordinate efforts to protect older Americans from abusive sales practices and investment fraud.

If a complaint is recommended, the Elder Law Attorney should review the contract and sales literature, request the "suitability" analysis and confirm that the agent involved is licensed. With this information in hand, the first person to contact is the agent who placed the annuity, then the company. Many companies are sensitive to consumer complaints and are eager to resolve customer issues. The Elder Law Attorney should not give up if the company will not grant requested relief after the first letter. The next step is to contact the state insurance commission, board or bureau that licenses agents and approves each contract sold within a state. Complaint forms are typically one page and are easy to fill out. Complaints can also be filed with the NAIC and with the NASD. Resorting to court action is the next step.

56. NASD has now become the Financial Industry Regulatory Authority (FINRA).
57. To view the SEC's website on investment scams against senior citizens see http://www.sec.gov/investor/seniors.shtml.
58. A complaint about a variable annuity should also be made with the state securities regulatory agency and with the North American Securities Administrators Association (NASAA).
59. Contact the NAIC at (816) 842-3600 or by email to communications@naic.org.
60. For more information, please visit http://www.finra.org.
XXII. CONCLUSION

Although annuities are more complicated than other investments, they offer unique advantages over other investments for the healthier senior. Deferred annuities can be annuitized into an income stream, whereas CDs, Stocks, bonds and most other investments cannot. Before an older client purchases an annuity, he/she should clarify distribution options available to himself/herself and to his/her beneficiaries. The client should also consider purchasing the annuity from a knowledgeable local financial planner to enable later service work to be efficiently accomplished in a face-to-face setting.

Finally, the client needs to keep all records of the original cost and later additions to and withdrawals from the annuity. This will be important to help the beneficiaries prove the basis in the contract in order to minimize tax. 61

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Sample NON-QUALIFIED DEFERRED ANNUITY QUESTIONNAIRE FOR ANNUITY OWNERS

By the Elder Law Firm of [ ]

1. Basic Information

- Name of Annuity Owner: ____________________________
- Age of Owner: ____________________________
- Name of Annuitant: ____________________________
- Insurance Company: ____________________________
- Financial Advisor: ____________________________
- Contract Number: ____________________________
- Date of Contract: Original Amount Invested: ____________________________
- Primary Beneficiary Designation: ____________________________
- Secondary Beneficiary Designation: ____________________________

2. Lifetime Planning Information

- Surrender Charge Schedule (years & percents): ____________________________
- Are 10% annual penalty-free withdrawals permitted?: ____________________________
- How much money can be withdrawn without any surrender charges?: ____________________________
- Are surrender charges waived upon death of owner?  
  Yes _______ No _______ N/A _______
- Are surrender charges waived if contract is annuitized?  
  Yes _______ No _______ N/A _______
- Are surrender charges waived upon owner’s confinement in a nursing home?  
  Yes _______ No _______ N/A _______
- Is contract fixed or variable?: ____________________________
- Does contract offer any minimum income or withdrawal benefits?: ____________________________
- What are the financial advisor’s planning recommendations for withdrawals/accumulation?: ____________________________
3. Post Mortem Planning Information

- What is the minimum death benefit (fill out one): Greater of investment in contract (less withdrawals) or contract value upon death:

  Other (describe):________________________________________

- Are the beneficiaries limited to a lump sum or a 5 year payout?:_____

- What kind of life-time stretch or annuitization payout options are available to the beneficiaries?________________________________________

- Are these automatic or must the owner elect them now?_________

- If a *Trust is named as Beneficiary, is the 5 year payout option available?

  Yes _______   No _______

*CAUTION: It is not recommended that a Trust own an annuity nor should the Owner and Annuitant be different persons.

*CAUTION: It is not generally recommended that a Trust be named as Beneficiary because of pay-out option limitations unless (1) the amount of the accrued interest is not a concern or (2) beneficiary protection is needed.

PLEASE RETURN THIS FORM BY MAIL OR FAX TO:

Elder Law Firm of [ ]

Client Consent

I, ____________________ hereby authorize ________ to release any and all information relating to my annuity investments to __________________________.

Name: ____________________________

Date: ______________________________
“The damage may already be done to the client’s annuity contract, when the elder law attorney arrives on the scene.”
Practice Guide for Non-Qualified Annuities

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- Medicaid Long-Term Planning
- Use of Annuities in VA Aid & Attendance
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More on Medicaid Compliant Annuities

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- “I want it now.”
- Joint ownership disinheri tance
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- Trust as Beneficiary
Practice Guide for Nonqualified Annuities
In Medicaid, VA & Tax Planning

By Robert C. Anderson¹, Certified Elder Law Attorney, LL.M Taxation

“The damage may already be done to the client’s annuity contract when the elder law attorney arrives on the scene.”

I. Medicaid Crisis Planning Issues
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¹ Robert C. Anderson is licensed in Michigan and Wisconsin at 148 W. Hewitt Avenue, Marquette, MI 49855 email rcanderson@upelderlaw.com
4. Surrender Charges Continuation After Death
5. Beneficiary Failures
6. Missing the Deadline in Selecting Deferral Options
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Practice Guide for Nonqualified Annuities

The damage may already be done to the client’s annuity contract when the elder law attorney arrives on the scene. Stuff happens. That stuff may include tax traps, unforeseen surrender charges, Medicaid estate recovery, and loss of guaranteed death benefits, just to mention a few. The same stuff the friendly annuity salesperson forgot to mention to your client when the annuity was purchased.

Throughout this article, nonqualified annuities will be referred to as “NQ annuities” or just “annuities.”

I. MEDIACAID CRISIS PLANNING

1. Surrender Charges May Apply if Annuity is Cashed

When Medicaid is needed, a deferred annuity is countable and may need to be cashed in. This will trigger a surrender penalty if the annuity is cashed in within the surrender period. The typical surrender periods range from 7-10 years. Example: an 83 year old client buys a $50,000 NQ annuity with an 8 year surrender period has a serious stroke at 85, and needs Medicaid assistance. The annuity still has 6 more years on the surrender period with a $6,000 surrender penalty. To qualify for Medicaid, the client will have to incur an unnecessary $6,000 product penalty as the annuity is cashed in to meet spend down.

Some companies offer waiver of penalty if a nursing home admission occurs.

Tax Deduction:

Keep in mind that the owner will receive a Schedule A itemized deduction equal to the amount received less the owner’s investment in the contract when the contract is surrendered. Therefore, the surrender charge will be included in the deduction as well as any market loss.

2. The Use of Medicaid Compliant Annuities

A. General Background
In a Medicaid crisis, a deferred NQ annuity does not always have to be cashed in. The annuity can be annuitized into an irrevocable income stream and, if properly structured, it will no longer be treated as a countable resource but rather under Medicaid’s more favorable income rules. Converting the annuity into income will not be treated as a divestment.

A second alternative to create annuity income is to invest countable cash into an immediate annuity.

Both the annuitization of a deferred annuity into an immediate annuity or the direct purchase of an immediate annuity from available cash must comply with the Deficit Reduction Act of 2005 (DRA) (§1396p(c)(1)(F) & (G)) and Section 3258.9(B) of the State Medicaid Manual (Transmittal 64, Nov., 1994).

Section 3258.9(B) of Transmittal 64 requires an immediate annuity to be “actuarial sound.” Actuarial soundness is achieved when the “expected return on the annuity is commensurate with a reasonable estimate of life expectancy of the beneficiary [the annuitant].”

If the payout period of the annuity is expected to go longer than the annuitant’s life expectancy, then the purchaser will not receive full fair market value, and as a result, the annuity will be treated as a divestment.

The payout period must not exceed the annuitant’s life expectancy-determined under the applicable State table. To comply, the annuity period must be a “period certain” or a “term certain” equal to or less than life expectancy.

The use of a “life payout” annuity period, which pays out for as long as the owner lives, will not satisfy actuarial soundness because payouts could extend beyond the table’s life expectancy. Nor will a “period certain and life” satisfy actuarial soundness because the payout period of such an annuity could extend beyond the period certain even if the period certain is less than the life expectancy.

With the implementation of the DRA in February of 2006, the actuarially soundness test of Transmittal 64 was continued subject to several modifications:
• It clarified and codified the rules regarding when an annuity transaction is to be treated as a transfer for less than fair market value.
• It required that the state be named as remainder beneficiary (subject to the preferred interest of the community spouse and minor and disabled children) to the extent of benefits paid.
• It required that applicants for Medicaid funded long-term care disclose their interest in annuities.

Generally speaking, the DRA rules now require that if an annuity is to be deemed “Medicaid compliant” it must:

• be irrevocable and non-assignable;
• be actuarially sound;
• provide for payments in equal amounts, with no deferral and no balloon payments; and
• name the state Medicaid agency as a beneficiary to the extent that medical assistance benefits were provided to the institutionalized individual.

Dale Krause, a national expert in this area, warns that very few insurance companies provide Medicaid compliant immediate annuities.

B. Married Couple Case Study.

The community spouse uses all cash assets above her/his community spouse resource allowance to buy a Medicaid compliant immediate payout annuity for a period certain – which is less than her/his life expectancy.

This will exempt the excess assets but may reduce the amount of income to be allocated from the nursing home spouse.

As mentioned above, the State Medicaid agency will be named as the primary beneficiary upon the community spouse’s death. To reduce this risk that annuity payments may be paid to the State, the annuity period could be shortened².

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² A good source of short term immediate annuities is Dale Krause of DePere, WI.
C.  **Half-A-Loaf for a Single Person.**

This strategy is quite complicated and mathematical. The general idea is that about 50% of a single person’s countable assets are given to loved ones – which creates a penalty period. At the same time, the other 50% is used to purchase a short term Medicaid compliant immediate annuity which will pay the nursing home bill during the penalty period.

D.  **Annuitization Problems.**

**Commutation Right.** The author has often found in the fine print of an immediate annuity contract that the owner may surrender the contract and take a commuted value. The right to assign the contract may also appear. These rights will cause the annuity to be countable or be treated as a divestment.

Some States Attempt to Say the Annuity Has Market Value.

For example, the State of Wisconsin challenges immediate annuities as countable resources because of the existence of the secondary market which buys immediate annuities at a discount.

II.  **MEDICAID LONG-TERM PLANNING ISSUES**

The cash surrender value of a NQ deferred annuity will be a countable asset for Medicaid purposes. However, the ownership of a NQ annuity, unlike an IRA, can be transferred to either another individual or a qualified irrevocable trust. This starts the 60-month Medicaid look-back period running against the State – which will eventually make the NQ annuity exempt from Medicaid spend down. Another positive feature is that the NQ annuity is tax-deferred so that the new owner will not incur current taxable income, unlike the transfer of a non-deferred taxable asset, e.g., a mutual fund.

1.  **Gift Tax on Transfers: a Non-Problem**

An ownership transfer of a NQ annuity is a completed gift which will require the filing of an IRS Form 709 if the value exceeds the $14,000 annual exclusion (2013). However, even if a gift exceeds the $14,000 annual exclusion, there is no gift tax nor even a penalty for failing to file
Form 709 as long as gifts are less than the $5.25 million lifetime exemption (2013).

2. **Loss of Deferred Status Due to Trust Transfers: a Non-Problem**

It may appear that Internal Revenue Code (IRC) 72(u) would discontinue the tax-deferred status of the annuity if the annuity is transferred to an irrevocable trust. However, this will not happen as long as the primary beneficiaries of the trust are human beings rather than charities or some other non-human beneficiaries. The following IRS Private Letter Rulings state that an irrevocable trust with human beneficiaries will qualify for tax-deferred status based on the theory that the trust is a mere agent of natural persons: PLRs 9204014, 9204010, and 19905015.

3. **Taxable Gains on Transfers: a Problem**

Even though the annuity owner may not owe gift tax on a transfer, the owner will have to pay income tax on the pre-gift accrued gain on the contract as ordinary income (not capital gain). See IRC 72(e)(4)(C). The gain on the contract is equal to the cash surrender value (not the current market value) less the donor’s net investment in the contract. The existence of any potential surrender charge would reduce the taxable gain.

The taxable gain paid by the former owner-donor is then added to the new owner’s tax basis – which will lower future taxable gain or any applicable pre-59½ early withdrawal penalty to be incurred by the new owner.

**Example:** Mary bought a NQ annuity in 2010 for $150,000. Mary transfers (gifts) the contract to her son in 2013 when the contract has a market value of $210,000 and a cash surrender value of $200,000. The decrease of $10,000 is because of potentially applicable surrender charges. Mary will report taxable income of $50,000 ($200,000 less $150,000) and the son’s tax basis in the contract will be $200,000 ($150,000 plus $50,000). However, gifts of annuities from one spouse to the other spouse are not taxable events. The spouse who receives the gifted annuity will receive a carry-over tax basis. (See IRC 1041).
Transfer to Revocable Trust:

A transfer of ownership of a NQ annuity into the owner’s revocable trust (a grantor trust) is not a taxable event. See IRS Rev. Rul. 85-13, 1985-1 C.B.184.

Transfer to Nongrantor Irrevocable Trust:

A transfer of a NQ annuity into a nongrantor irrevocable trust which is a simple or complex trust for income tax purposes will be a taxable event.

Transfer to a Grantor Irrevocable Trust:

There appears to be no IRS position on whether an ownership transfer into a grantor irrevocable trust is a taxable event – although most annuity companies will treat it as a taxable event and will issue a 1099 for the taxable gain to the donor. It is the author’s opinion that this is not correct because in other areas of income taxation involving grantor trusts, transfers into such trusts trigger no gain or loss under IRS Rev. Rul. 85-13, 1985-1 C.B.1984.

For Medicaid planning, it may be better not to fight the annuity company when it issues a 1099 on an ownership transfer into a grantor irrevocable trust. This is because the taxable event of the annuity transfer (a) cleanses out current income tax which will reduce the income tax against the beneficiaries who may be at higher income tax brackets, (b) allows the donor-Medicaid applicant to achieve greater spend down by pre-paying tax, and (c) allows for a future exempt income tax refund based on tax withholding.

4. 10% Withdrawal Penalties After Transfers: a Problem

IRC 72(q)(1) imposes a 10% penalty tax on the taxable portion of a pre-59½ distribution from a NQ annuity, similar to the 10% pre 59½ penalty from an IRA.

The penalty does not apply to the owner’s original investment in the contract. If the contract has no gain, there is no penalty.

Exceptions. Death, permanent disability of the owner, or attaining age 59½ are common exceptions. Other exceptions include an immediate
annuitization of the contract or taking it out in a series of substantially equal payments. IRC 72 (q)(2)(D).

Problem #1: Joint Ownership or transfers to a pre-59½ owner.

If the NQ annuity is owned by two owners, one of whom is under 59½, the 10% premature penalty may be imposed. To avoid this, it is best not to name more than one owner if one owner is under 59½.

The same problem will occur if an owner 59½ or older transfers the NQ annuity to someone under 59½. Such a transfer should not create an immediate problem for the new owner whose tax basis in the contract has been increased by the prior owner’s taxable gain. Therefore, a pre-59½ distribution to the new owner aged less than 59½ soon after receiving the annuity will neither be taxable nor result in a 10% early withdrawal penalty. However, later withdrawals, if made before the new owner turns 59½ will result in the 10% penalty on the taxable portion of the distribution earned after the earlier transfer.

Example: Herbert, aged 85, transfers his NQ annuity to his granddaughter, aged 40, for Medicaid planning purposes. There is $40,000 of taxable gain to Herbert – which is added to the granddaughter’s tax basis. Five year later, the value of the contract earns $10,000 when the granddaughter withdraws $10,000. She will be taxed on the $10,000 and will pay an early withdrawal penalty of $1,000 (10% of $10,000).

Problem #2: Transfers to an Irrevocable Trust:

Transferring a NQ annuity to an irrevocable trust may have a valid Medicaid planning purpose. However, it may result in an unexpected 10% premature withdrawal penalty to the extent of the taxable gain earned after the transfer. This is because an irrevocable trust as owner of a NQ annuity has no life expectancy, and therefore the post-59½ exception to the 10% early withdrawal penalty would not be available. In this connection, can you imagine the conundrum if the four primary beneficiaries of an irrevocable trust, which received ownership of a NQ annuity were aged 45, 50, 55, and 65 when a distribution of taxable gain was received by the trust? Three of the beneficiaries are under 59½ and one is over. Does this mean that ¾ of the distribution of the trust would be subject to the 10% penalty?
If a NQ annuity is transferred to an irrevocable trust, it would be wise to avoid distributions of earnings while the former owner-annuitant is alive in order to avoid the 10% premature penalty. Upon the death of the annuitant, i.e., the former owner, the problem disappears because the annuitant’s death ends any premature penalty.

The moral of the story is that it may not be wise to transfer a NQ annuity to an irrevocable trust unless there would be no need to make withdrawals from the trust prior to the annuitant’s death. A better approach may be to transfer a NQ annuity to an individual 59½ or older when Medicaid planning is needed.

III. USE OF ANNUITIES FOR VA AID & ATTENDANCE: The Good & The Bad

1. Introduction

The VA Aid & Attendance program has an asset limit. Transferring excess assets above the limit to loved ones is one method of satisfying the VA’s asset limit. A second method is to use the excess assets to purchase an immediate annuity. A potential negative consequence with such a purchase is that it may not qualify under Medicaid’s strict annuity rules if the veteran or spouse later need more assistance with care and enters a nursing home.

Other consumer protection issues are discussed as follows.

2. Consumer Notice to Veterans: Beware of Annuity Schemes for VA Benefits

This is to warn veterans of annuity sales schemes for VA Aid and Attendance benefits.

In a typical sales pitch, insurance agents who are not accredited by the U.S. Department of Veterans Affairs tell veterans to buy annuities so they can meet the VA’s asset limit for Aid & Attendance benefits, which can

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3 This Notice is authored by Robert C. Anderson, CELA and Christopher Berry, CELA and is published on the NAELA website in 2013.
pay a married veteran up to $2,054.33 per month or a single veteran up to $1,732.01 per month to help with home care or assisted living costs (2013). These non-service connected benefits require wartime service and other eligible rules. The surviving spouse of deceased wartime veterans may also receive up to $1,113.00 per month (2013).

The most common scheme is for a veteran to cash in his or her investments into immediate annuities which pay monthly income. Other veterans are persuaded by unaccredited insurance agents to transfer their life’s savings to a child who, at the agent’s urging, will buy a deferred annuity in the child’s name. In either case, the annuity will tie up the veteran’s finds for years, depriving the veteran of access to his/her funds when the funds may be needed.

The insurance agents neglect to mention that such an annuity purchase may result in violation of the VA’s income test under the Aid & Attendance rules. Moreover, the annuity may later result in Medicaid disqualification if the veteran needs nursing home care.

Common tactics by these insurance agents are to conduct veteran benefits speeches at senior citizens centers or assisted living facilities or offer free lunch or dinner seminars at motels or restaurants. The insurance agents then follow-up with annuity pitches at the veteran’s home.

These annuity sales may violate the rules of federal and state agencies. For example, under VA rules, only accredited attorneys and service officers may help veterans apply for VA benefits, at no cost. Insurance agents violate this rule when they provide advice on VA Aid & Attendance in connection with filing a claim. Such annuities sales may violate the Federal Trade Commission’s prohibition against unfair trade practices. If the annuity is a variable one, the consumer protection rules of the FINRA may be in play. Such annuities may violate the suitability rules of state insurance commissioners. Also, when the annuity advice by these agents involves legal advice, the advice may constitute an impermissible unauthorized practice of law.
3. **Proper Use of NQ Annuities in Aid & Attendance**

Fortunately, there are ethical insurance agents who understand VA and Medicaid rules or are willing to work with an experienced elder law attorney in designing an annuity.

Rather than give away assets above the VA’s asset limit to loved ones, a veteran or spouse may prefer to annuitize the excess assets in an immediate annuity. This allows the veteran or spouse to maintain the excess in their own name and preserve an extra income source to satisfy any income short fall in the cost of home care or assisted living or nursing home. If the annuity is also Medicaid compliant, then there should be no problem for Medicaid qualification if the veteran or spouse experiences a significant decline.

Such an annuity for VA Aid & Attendance is not a gift to loved ones, so it should have no negative impact with VA examiners nor if the proposed 2½ year look-back period if the Wyden bill becomes law.

However, there are reports that some VA examiners have challenged immediate annuities as being countable resources. One problem is that unlike Medicaid’s definitive immediate annuity rules, the VA has none. This gap in VA rules, invites unexpected challenges.

**Single Veteran Case Study**

**The Facts.**

John, a Korean War veteran is unmarried and is 84. John has Alzheimer’s disease and decides to enter Victoria Pines Assisted Living. John needs help with bathing and dressing and he gave up driving.

The cost of care at Victorican Pines is $4,000 per month and John has $200 per month of health insurance costs. His *unreimbursed* medical expense (UME) are $4,200.\(^4\)

John’s cash assets include $30,000 in a bank account and a $60,000 IRA. John’s social security is $1,200.

\(^4\) The VA will reduce UME by 5% of the base pension. But this doesn’t affect the analysis.
How to pay for the Monthly Shortfall

John’s monthly shortfall is:

(UME) Cost of care and medical $4,200
Less Social Security Income ($1,200)
Shortfall $3,000

John’s maximum A&A (MAPR) $1,703

Under the VA rules, John can still have an additional $1,297 of income to bring his total income up to meet the $3,000 shortfall and still receive full A&A benefit:

Shortfall $3,000
Less A&A maximum ($1,703)
Allowable extra income $1,297

The easiest way to bolster up John’s income is to rollover his $60,000 IRA into an immediate annuity (which can also satisfy Medicaid’s strict rules). Let’s assume that John buys a period certain annuity which is less than his life expectancy and equals the allowable extra income of $1,297.

John Later Enters a Nursing Home

Since the annuity is already Medicaid-compliant, Medicaid can easily be applied for. The State must be named as the beneficiary.

4. Impact of Wyden Bill on Annuities

Dawn Weekly, Chair of NAELA’s Veterans Task Force, provides the following report on the impact that the Wyden Bill could have on immediate annuities.

The Wyden Bill states, “…a transfer of an asset (including a transfer of an asset to an annuity, trust, or other financial instrument or investment) . . . “ results in a transfer penalty. Therefore, if the Wyden passes, immediate annuities which come into being within the VA look-back period will have diminished value. This VA rule is worse than Medicaid’s DRA rules on annuities, which contain an exception to divestment if the immediate annuity is irrevocable, nonassignable, less than life expectancy,
etc. Of course, if an immediate annuity was established beyond the VA look-back, it would have no cash value and would therefore be treated as income. The VA would not require that the VA be named as a beneficiary of the annuity, as Medicaid does. The VA has no Estate Recovery.

IV. POST-DEATH PITFALLS

When the owner of a NQ annuity dies, the force-out rule of IRC 72(c) will require the annuity proceeds to be available for distribution to the named beneficiary or beneficiaries. There are many pitfalls.

1. “I want it now”.

There is usually a rush to cash in the annuity. Sometimes the rush is motivated by the annuity agent to simplify service work for which there is no compensation. But in most cases, the rush is motivated by the beneficiaries’ desire for the cash now – without considering the tax advantage of spreading the applicable income tax over a number of years at lower brackets. The professionals involved should try to put the brakes on and to encourage consideration of available deferral options beyond a lump sum. The first step is to ask the annuity provider if the company will permit IRC 72(s) deferral options, such as up to five years, annuitization, spousal continuation, or systematic withdrawal over life expectancy. Available deferral options depend on who is named as beneficiary. Some companies will limit deferral options when a trust is named as beneficiary.

2. Accidental Disinheritance of a Joint Owner.

Joint ownership of NQ annuities should be discouraged because many annuity contracts pay the annuity to the designated beneficiary rather than to the joint owner. This could result in the accidental disinheritation of the joint owner. Normal joint ownership property rules for real property and bank accounts do not apply to annuity contracts which apply their own contract rules, independent of State law.

Example: Sally and John are married. They have no children, but do have a favorite niece. An annuity salesman sells them a $100,000 NQ
annuity and suggests they become “joint owners” and name the niece as beneficiary. Even though they intend the survivor of them should receive the annuity if one spouse dies, the annuity contract states that the “designated beneficiary shall receive the annuity proceeds upon the death of an owner.” So the niece receives the annuity when John dies, accidentally disinheriting Sally. The result would be different if the contract states that “a joint owner of an annuity is treated as the primary beneficiary and any designated beneficiary is treated as a secondary beneficiary.

The moral of the story is avoid joint NQ annuity ownership. Keep in mind that a NQ annuity is similar to an IRA which must be individually-owned. As between spouses, by naming one spouse as owner and the other as primary beneficiary, there will be no risk of a disinheriting of a spouse.

3. Losing the Guaranteed Death Benefit.

Many NQ annuity contracts come with an enhanced death benefit which guarantees that the death benefit will at least equal the contract’s purchase price even if the value of the annuity suffers a market decline.

Example: Sally buys a $100,000 variable annuity with a guaranteed death benefit. She names her husband John as the beneficiary. When Sally dies, the fair market value of the annuity dips to $70,000. Because of the guarantee, John receives $100,000.

There are several fine print contractual landmines built into annuity contracts that cause loss of the guarantee. Here are some of the common landmines:

a. Joint ownership
b. Trust ownership
c. Election of spousal continuation

The moral of the story is to carefully read the fine print of the enhanced death benefit contained in the annuity contract in order to avoid any disqualifying limitations.

Example using the same facts as above: In the fine print of Sally’s annuity contract, the death benefit guarantee is only available if the named beneficiary selects a lump sum settlement option. John is advised by his
tax adviser that he should elect a *spousal continuation* option “so that future income taxation can be minimized.” John follows the advice and receives $70,000 instead of $100,000.

4. **Surrender Charge Continuation After Death:**

Surrender charges during applicable surrender periods are contractual provisions which have few federal or state consumer protections. In most annuity contracts, surrender charges only apply while the owner is alive, and disappear when the owner dies. In some contracts, especially older ones, the surrender period continues after death.

Clients should ask the annuity salesman to confirm that the applicable surrender period ends upon the owner’s death. If not, the annuity should be exchanged for one whose surrender period does end upon death.

5. **Beneficiary Failures**

Clients should never assume that the primary beneficiary will survive the owner. The owner’s probate estate will become the default beneficiary. The careful naming of primary, secondary, and even tertiary beneficiary designations will avoid the probate of NQ annuity death benefits. As annuity companies sometimes merge or get bought out, their records of beneficiary designations may be lost. Therefore, it is important to collect and store written confirmation of beneficiary designations. The effective storage of written beneficiary confirmations will also prevent delays in filing claims.

6. **Missing the Deadline in Selecting Deferral Options.**

A beneficiary wishes to spread the taxable income in a NQ annuity over a number of years (i.e., a deferral option), there will be an election deadline. Unfortunately, IRC 72 contains two conflicting deferral option deadlines. Most annuity contracts adopt the one-year deadline as set forth in IRC 72(s), while others adopt the 60-day deadline as set forth in IRC 72(h).

In order to avoid a potential 60-day deadline, if applicable, professional advisors should immediately inquire which deadline applies.
7. **Failing to Take Advantage of Life-time Stretch Option.**

Many modern NQ annuity contracts provide beneficiaries with a lifetime stretch payout option similar to IRAs. Such an option not only permits tax on the accrued interest to be minimized, but may also allow the deferred contract to enjoy potential growth.

If the annuity contract does not permit a lifetime stretch option, the annuity may permit the beneficiary to transfer the contract without incurring a taxable event to another company which does permit a lifetime stretch option. Annuity companies are not required to permit such post-death transfers since they would violate the like-kind requirements of IRC 1035.

8. **Trust as Beneficiary.**

IRC 72(s) permits deferral of NQ annuity death benefits of up to five years when a trust is named as a beneficiary. Unfortunately, not all annuity companies allow the five year deferral option but instead require a lump sum payout when a trust is named as beneficiary. This is only a problem if there is a substantial untaxed interest in the contract.

Before naming a trust as beneficiary, it is important to confirm that the company permits the five year deferral option.
NQ ANNUITY QUIZ

1. If land and stocks are “green money” and IRAs are “red money: then a NQ annuity is:
   a. Pink money
   b. Gold money
   c. Yellow money
   d. This question is nonsense

2. What negative consequences will occur if a NQ annuity is transferred into an irrevocable trust?
   a. Loss of tax deferred status
   b. Accrued interest will be taxable to the prior annuity owner
   c. Surrender charges will be triggered
   d. All of the above

3. Which of the following methods prevent the 10% pre-59½ penalty for NQ annuities?
   a. Use of joint ownership
   b. Transfer ownership to a trust
   c. Annuitize the contract
   d. All of the above

4. What settlement options for a non-spouse does IRC 72 not offer to NQ annuities upon death of the owner?
   a. Lump sum option
   b. Withdrawal up to 5 years option
   c. Lifetime option
   d. Rollover option

5. Which of the following IRA tax rules do not apply to NQ annuities?
   a. The pre-59½ penalty
   b. Ordinary income tax treatment on earnings
   c. RMD 70½ rule
   d. Earnings are tax-deferred

ANSWER KEY:  1 (c); 2 (b); 3 (c); 4 (d); 5 (c)