

**EVALUATING COMMERCIAL ANNUITIES  
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## **PREFACE BY JEROME M. HESCH**

Alan Gassman and Christopher Denicolo are two lawyers whose primary objective is to do what is best for their clients. As part of this goal, they devote substantial time that cannot be billed to evaluate commercial products that may have significant limitations and hidden financial costs so that they can best advise their clients. As the Director of the Notre Dame Tax & Estate Planning Institute, I asked Alan to prepare and present a paper evaluating commercial annuity contracts for the 2013 Institute with the assistance of his able partner, and a former student of mine, Christopher Denicolo. That paper led Alan and Chris to prepare this book, as there was a need for an objective analysis of commercial annuities from someone who is not trying to sell a product. The material in this book takes into account that income tax planning has become more important as income tax rates have increased and that the estate tax is of less concern to the vast majority of taxpayers, especially individuals with a net worth that will not be exposed to the estate tax.

The insurance industry has developed a range of commercial annuities to provide individuals with lifetime guaranteed retirement payments that also have significant income tax advantages. Given that people selling annuities have a tendency to point out only their advantages, Alan and Chris have undertaken the responsibility to point out their limitations and also problems that may arise in the future. This book explains how variable annuities work, how they can be used to fill a number of different financial needs, including retirement planning, and their income tax and estate planning advantages. I expect that this book will be of use to estate planners who want to give their clients the best possible advice as the analysis needed requires the ability to evaluate the annuity product, determine the type of annuity best suited for the client, understand their financial and tax benefits, and point out their limitations and their costs.

*Jerome M. Hesch*

## **CHAPTER 1**

### **INTRODUCTION**

Variable, hybrid index, and fixed commercial annuity products have proliferated for a number of reasons, despite tax, expense and surrender charge characteristics that need to be considered. In many situations the ordinary income built up within an annuity contract can cause an unpleasant surprise for clients and their families. In other situations the deferral of income tax and creditor protection features make annuity products a worthwhile planning tool. Many planning techniques that are available for annuity arrangements are not well known to the estate and tax planning community, and include “income guarantees” and “loss prevention features” that are often misunderstood by investors and their advisors.

This book will provide a general introductory discussion of annuity taxation rules, and examines many strategies that can be used and traps to be avoided. Lawyers and accountants who are not usually involved in investment arrangements are well-advised to make sure their clients are educated and understand their options with respect to product offerings and situations already in progress.

The life insurance industry has been diligently creating annuity contract investments that provide tax deferral, financial stability, and beneficiary designation rights that avoid probate to make their products as attractive as possible while offering large commissions to sales organizations that are often multiple times those that would apply to conventional mutual funds, stocks, and bonds. As a result, the industry is saturated with complex and confusing products, which often advertise “guaranteed income,” “market rates of return with no risk,” and similar “golden tickets,” which seem incongruous or too good to be true. In many cases the product description is not entirely accurate or the subject at hand is vague and easily open to misunderstanding. There are many other traps for the unwary which arise from the tax and legal nature of these labyrinthine contractual arrangements.

During the 2008 financial crisis, fixed annuities kept their value and variable annuities with guaranteed payment features saved many investors from horrendous results because they did not feel pressured to pull equity investments out of the market.

On the other hand, the annuity contract industry has created many products that have high internal costs and multiple year surrender charge schedules that must be considered before acquiring or changing an annuity arrangement. Distributions of variable annuities will typically be taxed at the ordinary income rate, and sometimes at 10% above the ordinary income rate.

Taxpayers and their advisers are well advised to carefully review annuity offerings and to understand that they are often more complicated and controversial than CDs, bonds, mutual funds, and almost all other categories of investments.

The vast majority of annuity contracts are issued by nationally recognized carriers and regulated by state insurance commissioners and federal agencies as well. Additionally, there is an active offshore and “private placement” community that can provide more flexible and, in some cases, very creative planning opportunities for large investment portfolios or single purpose family or personal investments.

The primary features of a number of presently available annuity products are reviewed below in order to help give the reader a sense of how to compare various products as well as opportunities and issues associated therewith. A sample client letter that reviews several annuity products is enclosed as part of this book. The letter reviews a number of charts that illustrate and help to explain a number of tax and financial result scenarios which demonstrate how various arrangements work and what the actual results will be under differing factors, including cost, growth, years of duration, and tax rates. These charts and Excel spreadsheets are all available by email upon request (please email [agassman@gassmanpa.com](mailto:agassman@gassmanpa.com)). Some of the charts have been created by or with the help of John Prizer, a financial planner from Maitland, Florida ([John@SimpleFS.com](mailto:John@SimpleFS.com)), who has spent many hours helping us to refine and understand the analysis herein provided.

The annuity contracts referred to in this book are commercial annuity contracts held by individuals and trusts, and not contracts that may be held as IRA annuities or under pension or other qualified retirement plans. Those annuities are subject to separate rules and are typically not appropriate for many individual taxpayers because of the lack of any additional tax benefit than what is afforded under the qualified plan taxation rules.

Separate and apart from annuities is the related world of cash value, universal, variable and whole life insurance, all of which share a number of common characteristics with annuities. The main differences between an annuity and a life policy are that life policies have large death benefits and mortality risk expenses while annuity contracts typically do not. Moreover, permanent life insurance often costs more and results in much larger commissions to agents who sell it. Life insurance policy loans do not normally trigger tax to the policyholder (unless the policy is considered to be a “modified endowment contract” under Section 7702A), which essentially allows for the tax-free withdrawal of cash from policies with a cash value component. If the policyholder dies while the policy is in place, there will normally be no income tax imposed on the growth within the policy, even if the cash value of the policy has been borrowed out within established guidelines and the loan is repaid from policy proceeds. But a cashed in, lapsed, or transferred life insurance policy can trigger taxation in unexpected and very costly ways because the investment in the contract (the basis) of a life insurance policy is reduced to the extent that dividends earned by the cash value have been used to pay death benefit cost. Anyone advising clients who have permanent life insurance policies should be sure to understand the many rules that apply in that area. These rules are beyond the purview of this book.

Some of these tax rules may also apply to private annuities, which are arrangements that could be entered into between individuals or family members and family entities like trusts and companies. Private annuity structuring is beyond the scope of this book.

We thank Christopher Price of Lincoln National, Michael Morrissey of Vanguard, and Ryan Chaplinski of Dimensional Fund Advisors for their valuable input and advice in the preparation of this book.

The authors are tax and estate planning lawyers who do not sell or derive any commission or other compensation from the sale, maintenance, endorsement or criticism of commercial annuities or any other product. Other books are available that have been written by individuals who do derive income from selling and maintaining commercial annuities. Those books can be referred to for more information and a different approach to the subject. When you buy a book written by somebody who sells the product, you can expect a possible bias towards that product. In fact, Michael Davis, a financial consultant who is listed in “the Top 250 Wealth Advisors” in the October 2008 issue of Worth Magazine and one of “the 150 Best Financial Advisors for Doctors” in the November 2010 issue of Medical Economics has indicated that “many people in the financial services industry have a

vested interest in keeping people confused. Because if you really understood what was being pitched to you, you would run in the opposite direction.”

Much thanks to Michael Kitces – just before completing this outline we became aware of a number of articles and studies prepared by Michael Kitces who is a Partner and the Director of Research for Pinnacle Advisory Group, and publisher of the financial planning industry blog Nerd’s Eye View. Mr. Kitces has permitted us to reproduce five of his articles, which are as follows:

- Do Today’s Guaranteed Living Benefit Annuity Riders Really Offer Enough To Be Worthwhile? Page 17-120
- Can Variable Annuities Really Offer Insurance Guarantees Against A Market Catastrophe? Page 17-124
- AXA And Hartford Prospectus Changes A Troubling New Trend For Existing Variable Annuities Page 17-134
- Why It Rarely Pays To Wait On Taking Withdrawals From A Variable Annuity GLWB Rider – A Case Study Page 17-169
- Why The New Qualifying Longevity Annuity Contract (QLAC) Regulations Don’t Mean Much For Retirement Income.....Yet? Page 17-299

Some representative quotes from Mr. Kitces from emails that he has exchanged with the authors are as follows:

In practice, yes I have a LOT of concerns about how indexed annuities are marketed today. Many firms give mediocre or misleading comparisons (or none at all), or illustrate products at unrealistically high and very-not-guaranteed rates, even though sometimes there's virtually no chance that the spreads/caps/participation rates will remain where they are (the equivalent of illustrating a temporary "teaser rate" as though it's permanent). Not that all indexed annuity products are necessarily bad, but many of them are problematic and unfortunately because the sales tactics are so poorly regulated and overseen, the bad products that are over-illustrated unrealistically have driven away many of the actually good products that were illustrated at less-favorable-but-actually-realistic rates.

When commenting on one of the spreadsheets that is being provided in this outline Mr. Kitces states as follows:

I haven't audited through the numbers here in depth, but yes this looks on track to me. Realize, though, that it's awkward to compare because their "dynamic" fund can basically own whatever it wants. If there's a market crash like 2008 and the company is concerned it may be exposed to losses, they can put you in CASH if they want. There's no particular reason that you would necessarily be fully invested over the whole time horizon to begin with. Similarly, the caps/spreads/participation rates can change over as well. Note that the policy states that they could apply a spread as high as 12% (who buys an investment where the company at its own discretion could raise its expense ratio to the equivalent of 12%!?), and similarly can make the annual cap as little as 0.25%. So the problem, for better or worse, is that your projections assume that the current caps/spreads/participation rates will remain stable, but the company has absolutely no actual obligation to do so.

## CHAPTER 2

### **ANNUITY CONTRACTS IN A NUTSHELL: KEY CONCEPTS AND TERMINOLOGY FOR THE TAX ADVISOR**

This summary reviews the basic rules, vocabulary, and primary planning techniques for annuities to familiarize the reader with concepts and introduce key definitions for working with these concepts. This nutshell is for any reader not familiar with these concepts. The technical definitions and terminology used under the Internal Revenue Code (hereinafter referred to as the “Code”, and the word “Section,” refers to the applicable section of the Code). Treasury Regulations, Revenue Rulings, and Private Letter Rulings can be confusing, because the tax law definitions and assumptions do not always match the actual nature and names given to annuity products and design features. This nutshell is intended to be a practical guide, but we have spared the reader the hours that it would take to become familiar with all definitions, terminology, and nuances.

Each of the concepts and techniques described in this summary are more extensively covered in the book.

#### **Basic Annuity Terms and Concepts**

“**Annuities**” are contracts offered by insurance companies that provide a return on investment that may be based on underlying subaccount investments or a rate of return paid by the insurance carrier. Treasury Regulation 1.72-2(a) (1) defines an annuity as a contract that is considered to be an annuity contract within the customary practice of life insurance companies. A contract holder, or “**owner**,” pays the insurance company money and the company makes disbursement payments to the owner or the beneficiary.

“**Annuitizing**” a contract means that distributions are paid out over the life expectancy of one or more designated individuals, over a term of years, or a combination of both<sup>1</sup>. Converting an annuity to an annuitized annuity is referred to as “**annuitization**.”

“**Partial annuitization**” is when any amount is received as an annuity from a portion or part of a larger deferred annuity. It is authorized under Section 72(a) (2) if the payment period is for at least 10 years or during one or more lives under any portion of an annuity.

The total amounts paid into the contract are the cost basis, referred to as the “**investment in the contract**.” Any money earned within the contract, like interest or growth in underlying funds, is called “**income**.” Income is not recognized until there is a withdrawal or another triggering event, and is reported on Form 1099-R. The investment in the contract is not increased by income or reduced by losses that may occur within the contract. The “**account value**” is the value of underlying assets in the annuity. For convenience, this nutshell will sometimes refer to the investment in the contract as “**basis**,” and income as “**built-in income**.”

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<sup>1</sup> Section 72(b) provides that the recipient does not have any gross income from annuity payments to the extent that part of any payment received that bears the same ratio to such amount as from an annuitized annuity in the contract bears to the expected return under the contract, provided that this exclusion is limited to the unrecovered investment in the contract. In other words, if part of the annuity payment consists of a return of the taxpayer’s basis, then that portion of the payment is not considered income. Otherwise, distributions from an annuity are 100% taxable to the extent that income or growth has occurred within the contract.



“**Life expectancy**” is a prediction of the number of years an individual is expected to live from their current age. Insurance companies use their own life expectancy assumptions or industry standard life expectancy tables to estimate the length of time they will make payments when the payment period is for one or more lives.

“**Expected return**” is the total amount of the payments that the owner is expected to receive from an annuitized annuity. The expected return is based on either life expectancy or the total amount of the expected payments.

Typically, payments are made until someone’s death. The person whose life is used to determine the length of the payments is called the “**annuitant**.” Usually there will be either one or two annuitants with payment or accumulation rights lasting until the death of the surviving annuitant. Sometimes, the owner does not have to use his own life as the measuring life. However, some policies require the owner to be the annuitant. The owner may want someone else to be the annuitant for a number of reasons. For example, James is 80 years old and has an annuity. When he dies, he wants any remaining payments to go to his niece, who is 55 years old. James will not want to use his own life as the measuring life for annuitized payments as that would cause payments to cease at his death. Instead, James may name a younger, healthy individual as the annuitant, such as his 55 year old niece.

“**Annuitization risk**” is the financial risk taken by the insurance company when an annuity will be payable for the lifetime of one or more persons. The life insurance company risks running out of investments that would be used to make the guaranteed payments. This would really become the policyholder’s risk if the life insurance company becomes insolvent and becomes bankrupt. The policyholder is taking a risk that the annuitant will die before his life expectancy and will not receive a profitable amount of payments. The insurance company is taking a risk that the annuitant will live longer than his life expectancy and make more payments than predicted.

### **Types of Annuities: Fixed v. Variable and Immediate v. Deferred**

All annuities are described with two words: fixed or variable, and immediate or deferred. In other words, there are four types of annuities: fixed immediate annuities, fixed deferred annuities, variable immediate annuities, and variable deferred annuities.

#### ***Fixed v. Variable Annuities***

Until the 1980s, the vast majority of annuity contracts and investments consisted of arrangements where an individual would give money to a life insurance company in exchange for the right to receive equal annual payments for their lifetimes. These contracts are called “**fixed annuities**.” Fixed annuities earn a fixed or carrier-designated interest rate and pay out fixed amounts of money, so investment risk is transferred from the policyholder to the insurance carrier.

In the 1990s, “**variable annuities**” became popular because they allowed for indirect investment in securities and income tax deferral. A variable annuity is an annuity whose account value varies depending on the earnings and subaccount investments in the contract. Many variable annuities are established with subaccount investments that generate ordinary income, including hedge funds. Annuity carriers are not permitted to refer to underlying investments as mutual funds, although they are virtually identical to mutual funds and were both created under the Investment Company Act of 1940. Carriers, and this book, refer to such investments as subaccounts. With variable annuities the investment risk is retained by the policyholder, although this risk might be reduced through policy features or riders such as death or living benefits. Death benefits can include

contractual guarantees that the policy value on death will be no less than the actual contributions made to the policy, less policy charges and withdrawals. Living benefits can include a guarantee that annual payments can be received from the contract, even if the contract value goes to zero because of poor investment results.

A hybrid of the traditional variable annuity is the “index annuity.” As explained in Chapter 6, the insurance company may invest monies received in bonds, and use the interest earned on the bonds to purchase complicated financial participation rights that will enable the product to realize gains if certain market indexes go up. These have a financial result somewhat similar to variable annuities by capturing some of the upside if the market goes up, while having most of the value held in bonds that are normally considered to be safe if the market goes down. An example would be a product that promises that if the stock indexes are negative for a particular year, then the cash value will not go down, and if the chosen indexes go up by 10%, the cash value may go up by only 6.2%. These products typically pay the same commissions and have “guarantee” features similar to normal variable annuities, so one would assume that the carriers expect to earn between 3%-4% per year in order for these products to be profitable.

### ***Immediate v. Deferred Annuities***

An “**immediate annuity**” exists when the owner pays a single premium and receives at least one scheduled payment from the carrier within 365 days of the purchase date. An immediate annuity may provide for payments over a number of years and still be considered immediate, so long as the first payment occurs within the first 365 days of the contract purchase date. Further, an immediate annuity provides for a series of substantially equal periodic payments which are paid at least annually.

Under a “**deferred annuity**,” payments begin more than one year after the purchase date. Deferred annuities allow interest to accumulate on a tax-deferred basis. The interest that accrues is considered income for tax purposes.

In its most traditional form, an annuity was a contract where a widow gave an insurance company a sum of money, say \$1,000, and the insurance company gave the widow \$10 a month for the rest of her life. This is referred to as an “immediate annuity,” or more specifically, an “immediate fixed annuity.” An immediate fixed annuity has two unique characteristics: (1) the first payment is made in the first year; and (2) the payments are specific fixed dollar amounts that do not vary with market performance or otherwise. As explained below, payments received under an immediate annuity are only taxable to a certain extent each year, as opposed to payments from many other types of annuity arrangements being completely taxable each year until all income has been paid out.

Once the insurance company receives its premium, the contract is set in stone, unless cancelled within the statutory period after delivery. The term of payments is fixed at either a set of number of years, over your lifetime, or some combination thereof. The taxpayer can only receive his or her money back in terms of annuity payments, with a few exceptions. There may be, in some instances, a refund guarantee which says that if you die before you get all of the payments, or before a certain year, then your family receives additional monies.

### **Basic Income Tax Concepts and Implications of Annuities**

The federal government imposes a progressive income tax on all individuals whose income reaches certain levels. The IRS taxes ordinary income at the taxpayer’s top marginal rate. In 2014, married couples whose income exceeds \$457,600 and single individuals whose income exceeds \$406,750 have a top marginal rate of 39.6% (the highest ordinary income tax bracket). These income

thresholds adjust annually for inflation. Ordinary income includes income earned or received from wages, working as an independent contractor, IRA and pension accounts, and annuity contracts.

For 2014, the 35% ordinary income tax bracket applies to both married couples and single individuals with income of \$405,100 or greater.

Mutual fund investors receive tax statements that require them to pay income tax based upon the internal capital gains and dividends of the mutual fund, most of which are taxed at 20% for taxpayers who have \$406,750 or more in taxable income if single and taxpayers who have \$457,600 or more in taxable income if married. For example, if a married couple had \$457,600 of ordinary income and an additional \$100,000 in long-term capital gains and qualified dividends, then the entire \$100,000 would be subject to the 20% rate. If, however, they only had \$400,000 of other taxable income, then \$57,600 of the additional amount would be taxed at 15% and \$42,400 would be taxed at 20%.

Capital gains and dividend income are therefore much preferred over ordinary income in most situations, and annuities that own mutual funds or similar investments will allow deferral of income from capital gains and dividends within the contract, but convert these to ordinary income when they are paid out.

Some taxpayers have significant medical and home nursing or similar expenses. An individual taxpayer may deduct expenses for his or her medical care which are not covered by insurance to the extent such expenses exceed 10% of the taxpayer's adjusted gross income. Therefore, many elderly couples may have significant income tax deductions in later years that would offset income paid in annuity contracts or similar arrangements.

Beginning in 2013, the Affordable Care Act subjects certain taxpayers to a 3.8% Medicare tax on net investment income. The Affordable Care Act imposes this tax on particular types of passive income of single individuals who have an adjusted gross income in excess of \$200,000 and married couples with an adjusted gross income in excess of \$250,000. Income paid from an annuity contract will be subject to the 3.8% Medicare tax, as are dividends, interests, and capital gains to the extent that taxpayers' total adjusted gross income exceeds the above thresholds.

### ***Determining the Taxable Portion of an Annuity Payment***

There are two ways to tax an annuity: before the contract annuitizes and after the contract annuitizes. If withdrawals are made before the contract annuitizes, then the "**Last In, First Out**" (LIFO) rule, or the "**interest first**" rule, applies. Unless an exception applies, income that occurs under an annuity contract will be recognized first, without any credit given to the investment in the contract until all income has been withdrawn. The LIFO rule applies to both fixed and variable annuities.

As a result, it makes sense to have multiple annuities so that cashing in or taking large withdrawals from one annuity would facilitate the withdrawal of principal. For example, Mary has one annuity worth \$100,000 and costs \$80,000. If she wants to withdraw \$40,000, then there would be \$20,000 of income tax. If Mary owned two \$50,000 annuity contracts with \$10,000 of income in each of them, then a \$40,000 withdrawal from one of them would only carry out \$10,000 of taxable income. The "**Aggregation Rules**" described below limit the ability to do this.

After a contract annuitizes, the code applies an "**exclusion ratio**" to each payment. The exclusion ratio works differently, depending on whether an annuity is fixed or variable.

For fixed annuities, whether immediate or deferred, the periodic payment amount is multiplied by the exclusion ratio to determine the part of each payment that is not taxable. The exclusion ratio is the investment in the contract divided by the expected return under the contract. Or put another way:

$$\frac{\text{Investment in the contract}}{\text{Expected return}} = \text{Exclusion ratio}$$
$$\text{Non-taxable income} = \text{Payment amount} \times \text{Exclusion ratio}$$

For example, Frank buys a fixed annuity for \$100,000 and will receive \$12,000 per year for life. Assume that his expected return is \$150,000. Frank's exclusion ratio is \$100,000 divided by \$150,000, or 66.67%. The amount of Frank's payments that are excluded from tax is \$12,000 times 66.67%, or \$8,000. Only \$4,000 out of \$12,000 in payments received will be taxable each year.

For variable annuities, the amount of each payment is unknown. Therefore, the expected return on the contract cannot be predicted and must be estimated. The tax-free portion of each payment received from a variable annuity is the investment in the contract divided by the expected number of payments. The expected number of payments replaces the expected return. Or put another way:

$$\frac{\text{Investment in the contract}}{\text{Expected number of payments}} = \text{Exclusion ratio}$$
$$\text{Non-taxable income} = \text{Payment amount} \times \text{Exclusion ratio}$$

For example, Veronica buys a variable annuity for \$100,000 and expects to receive one payment a year for the next 20 years. The tax-free portion of each payment received by Veronica is \$100,000 divided by 20, or \$5,000 (i.e., her exclusion ratio). This means that \$5,000 of each of Veronica's payments is not taxable. If Veronica receives more than \$5,000, then the amount exceeding \$5,000 is all taxable income. If she receives less than \$5,000, then the entire amount is excluded from taxable income and Veronica's insurance carrier will recalculate her exclusion ratio under Treasury Regulation 1.72-2.

The exclusion ratio only applies once the contract annuitizes. If money is withdrawn from the account before the contract annuitizes, then the LIFO rule applies.

Annuity contracts can be sold with commission loads or with no load. Many insurance companies impose "surrender charges," or withdrawal fees, when annuity contracts terminate within a certain time period as a way to assure that they will recover commissions and sales costs. On the surface it might seem that a no load product would always be preferable to a product with a sales charge, but if the no load product is provided by a financial advisor then that advisor may add or wrap additional fees around the product, which should be considered.

A typical surrender charge schedule is as follows:

Surrender in Year 1--	7% charge
Surrender in Year 2--	7% charge
Surrender in Year 3--	6% charge
Surrender in Year 4--	6% charge
Surrender in Year 5 or later	0% charge

## **10% Excise Tax**

A 10% excise tax applies under Section 72(q) when income is withdrawn from a fixed or variable annuity, unless one of the following exceptions applies:

- The owner is an individual who makes the withdrawal after reaching age 59½;
- An immediate annuity;
- Where the owner of an annuity contract dies;
- Where the owner becomes disabled; or
- Payments are part of a series of substantially equal periodic payments, made at least annually, based on the life of the taxpayer which are paid for the longer of 5 years or the taxpayer attaining age 59 ½.

The 10% excise tax works by adding 10% to the tax rate that would normally apply for the taxpayer. For example, if the owner withdraws income and is in the 39.6% tax bracket, the annuity income will be taxed at 49.6%. Further, the 3.8% Medicare tax applies to single individuals who earn more than \$200,000 a year or married individuals who earn more than \$250,000 a year. Therefore, the tax rate would be 53.4%. In addition, state income taxes might apply as well.

The IRS has been known to interpret the substantially equal periodic payments exception narrowly. In practice, taxpayers can meet the substantially equal periodic payments exception by exercising a systematic withdrawal option under the contract, if available. However, if a taxpayer changes the substantially equal payments before attaining age 59 ½ or within five years of the first payment, then the taxpayer will be taxed as though the exception did not apply. The 10% excise tax would therefore apply beginning in the taxable year in which the modification occurs and thereafter, and a recapture of the tax that would have been owed in the prior taxable years but for the substantially equal payments exception, plus underpayment penalties and interest, will also apply.

### **Chart Summarizing How Fixed and Variable Annuities are Taxed**

Type of Annuity	Tax Treatment	10% Excise Tax
Immediate Annuity	Exclusion Ratio Treatment	Doesn't apply - immediate annuity exception
Deferred Annuity Withdrawals Prior to Annuitization	LIFO	Applies - Unless an exception is met
Deferred Annuity After Annuitization	Exclusion Ratio Treatment	Applies - Unless an exception is met

## **Taxation on the Death of the Owner or Annuitant**

Withdrawals are required to occur within a certain time of the death of the annuitant(s) or the death of the owner, depending on the contract. This is a “**death benefit**,” and it is often nothing other than the account value on the date of the post-death termination, although many variable annuity contracts offer enhanced death benefits that may pay in excess of the account value. If the contract is designed around the death of an annuitant, it is called an “annuitant driven contract,” and the death benefit is paid out when the annuitant dies. If the contract is designed around the death of the owner, it is called an “owner driven contract,” and the death benefit is paid out when the owner dies.

Death benefits are paid out to the “**beneficiary**” and include the income remaining in the contract.

Generally, if the annuitization of the annuity has already occurred, then the annuity contract must be paid out “at least as rapidly” as the method of distributions being used as of the death of the owner, and if annuitization has not yet begun, then the annuity contract must be paid out within five years of the death of the owner. An exception to this general rule for non-annuitized contracts applies where the annuity contract allows any portion of the holder’s interest in the contract to be payable to (or for the benefit of) a “designated beneficiary.” Such portion will be distributed over the life expectancy of such designated beneficiary, and such distributions begin no later than one year following the holder’s death. If these requirements are met, then the designated beneficiary can receive tax-deferred distributions (i.e., a portion of each payment will be free from tax based on the exclusion ratio) of the proceeds over his life expectancy if the death benefit is received in the form of an annuitized payout. Otherwise the LIFO rule will apply.

## **Trusts as Owners of Annuity Contracts**

Under Section 72(u), if any deferred annuity contract is not held by a person who is a “**natural person**,” then such contract will not be treated as an annuity contract for the purposes of the Code. In such event, the taxpayer must recognize the income on the contract for a particular taxable year equal to: (1) the sum of (a) the net surrender value of the contract; and (b) all distributions received by the taxpayer during the applicable year; less (2) the sum of the net premiums paid on the contract; and any amounts includable in gross income for prior taxable years.

This is illustrated by the following example:

ABC Corp. acquires a deferred annuity for \$100,000. ABC Corp. compares the values at the beginning and the end of the year. In Year 1, the account value under its annuity appreciates from \$100,000 to \$120,000, so it reports \$20,000 of income and its investment in the contract increases by \$20,000. In Year 2, ABC Corp.’s account value depreciates in value by \$10,000 to \$110,000, so it does not have any income from the contract for Year 2. In Year 3, the net surrender value under its contract appreciates to \$125,000. ABC Corp. still has \$120,000 of basis, so its Year 3 taxable income is \$5,000, and its investment in the contract (basis) will increase by \$5,000.

As illustrated by the example, the advantageous tax treatment afforded by annuity contracts (other than an immediate annuity) is unavailable if the contract is owned by a “non-natural” person. It is therefore important to consider whether a trust holding an annuity contract is treated as a “non-natural” person under Section 72(u).

There are several Private Letter Rulings that support this. The IRS has held that trusts holding annuity contracts did so as “nominees” for the individual trust beneficiaries thereof<sup>2</sup>. What these Rulings have in common is that the beneficiaries of the trust were all individuals, and the Rulings conclude that the trust is holding the contract for their benefit. However, these Rulings involved situations where the terms of the trust provided for the eventual distribution of the annuity contract to the “nominee” beneficiary, or provided for the mandatory distribution of income to a specifically named individual trust beneficiary. It could be argued that an irrevocable trust with multiple beneficiaries that allows the trustee to make health, education, maintenance and support distributions to beneficiaries based upon the trustee’s discretion (but does not provide for the outright distribution of the annuity contracts to the beneficiaries or the mandatory distribution of income) is not holding the contract for the benefit of natural persons because there is no obligation to provide these individuals with any benefit. Therefore, the trust cannot be holding the contract for their benefit. On the other hand, if the current beneficiaries are not entitled to receive any benefit from the trust then the benefit will accrue to some future or remainder beneficiary. If all of the beneficiaries are natural persons, then the argument can be made that the contract is held for the benefit of natural persons. This latter view is widely held by insurance carriers. Regardless, there is no authority directly on this point.

### **Gifting an Annuity**

Section 72(e)(4)(C) provides that an individual who gifts a deferred annuity contract is considered to have received an amount equal to the excess of the cash surrender value of the contract over the individual’s investment in the contract at the time that the gift is made. The amount considered as received is treated as ordinary income to the transferor, at the time of the transfer. An exception applies when the donee is a spouse or the transfer is incident to a divorce. The donee spouse will have the same investment in the contract as the donor spouse had.

The 10% excise tax might also apply to the income recognized on the gift, unless one of the exceptions described above pertaining to Section 72(q) applies.

### **Aggregation Rules**

When one taxpayer purchases multiple contracts from the same carrier during a given calendar year, the aggregation rule applies whereby Section 72(e)(12)(a)(ii) treats these contracts as if they were one contract for purposes of making withdrawals. However, the aggregation rule does not apply if the contracts are purchased from separate carriers, if they are purchased in separate calendar years, or if they are purchased by separate spouses, even if they file joint tax returns.

The aggregation rule was developed to prevent taxpayers from circumventing the Last In First Out rule, but is subject to the exceptions noted above. The 1035 Exchange rules contain another aggregation rule that is applicable to Section 1035 exchanges, as described below.

### **1035 Exchanges**

Deferred annuity contracts can be exchanged under Section 1035 without triggering income tax. These contracts can be exchanged on a tax-deferred basis for other annuity contracts or for home health or lifetime care contracts. Annuities cannot be exchanged tax-deferred for life insurance policies or endowment contracts. Life insurance policies and endowment contracts can be exchanged

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<sup>2</sup> PLRs 9204014, 9204010, 9752035 199905015, and 201124008

tax-deferred annuities. While the owner of a deferred annuity can exchange it on a tax-deferred basis for an annuitized contract, it will not be considered an immediate annuity contract if this occurs within 12 months of acquisition of the original contract.

The owner of a life insurance policy that has a cash value exceeding the tax basis may be well advised to exchange the excess amount for an annuity contract, to facilitate having lower costs imposed on the investment component of the arrangement. The owner may withdraw an amount equal to the tax basis from the life insurance policy on a tax free basis before making the exchange. The annuity contract exchanged into will normally be less expensive, and can be composed of 100% income that may not be taxable until it is withdrawn. Some annuities have long-term care benefits so that such an exchange could result in converting pre-tax policy gains to tax free long-term care benefits.

In a 1035 exchange, the owner of the first contract must be the same owner of the new contract received in the exchange. The annuitant cannot be changed during the exchange. However, the annuitant may be changed before or after the exchange, if the carrier permits this.

One annuity contract can be exchanged for two or more contracts and vice versa. However, the multiple contracts must be invested with different carriers to avoid the aggregation rule. The IRS has expressed concern that the holder of an annuity contract might exchange one large contract for multiple small contracts in order to withdraw from the smaller contracts to defer taxes. The 1035 aggregation rule was designed to prevent this by disqualifying the partial exchange of an annuity contract as a 1035 exchange if a withdrawal is received (other than amounts received as an annuity) from either contract involved in the exchange during the first 180 days after the exchange.

However, it is possible to complete a partial exchange to avoid the 1035 aggregation rule. A partial exchange is the direct transfer of a portion of an existing annuity contract to another annuity contract. Under Section 72(e), a partial exchange is tax-free if no amount, other than an amount received as an annuity, is received during the first 180 days after the date of the transfer. The original contract and the new contract are not subject to the aggregation rule, even if the partial exchange is with the same company.

For example, John has a \$200,000 deferred annuity contract. \$100,000 of the annuity is the investment in the contract and \$100,000 is income. John wants to withdraw \$50,000, but the entire amount will be taxable income. John can take \$25,000 of the investment in the contract and \$25,000 of the income and exchange that portion of the original annuity contract for a new annuity contract. As long as John does not receive any amounts from the new contract other than amounts received as an annuity for 180 days after the exchange, the exchange is tax-free. After the exchange, John will still have the original annuity contract, with a \$150,000 account value, and a new contract, with a \$50,000 account value. After 180 days John can cash in the \$50,000 contract and will recognize only \$25,000 of taxable income on such withdrawal.

### **Guarantees and Insolvency Concerns**

Many states have guarantee funds that will replace the value lost if a fixed annuity defaults because of carrier insolvency. These guarantees generally do not apply for the variable account values of variable annuities but will often apply to various insurance company guarantees such as living and death benefits, which are described above. However, if an insurance carrier fails while holding subaccount investments under variable annuities, then the value should not be lost because the carrier does not own the subaccount investments. Rather, the carrier holds them apart from their assets for the policyholders. Variable annuities that held Madoff funds lost value, and the investors



had no recovery rights as compared with Madoff funds that were held under SIPC accounts (Securities Investor Protection Corporation), which qualified for recovery of up to \$500,000 per account. Nevertheless, variable annuities that were holding Madoff funds, while Madoff funds were held directly under SIPC accounts, qualified for payments of up to the \$500,000 limit.

### **Synthetic Annuitized Contracts**

Internal Revenue Service Private Letter Rulings have demonstrated that it is possible to have an annuity contract invested in mutual funds which is scheduled to pay fixed annual or more frequent payments, which may be altered in the future. The result of this arrangement can be a variable annuity contract which is treated as a fixed annuity for the purposes of being able to allocate cost to payments received and to avoid the 10% penalty cost on withdrawals where the owner is not an individual over age 59½. One insurance carrier has patented the administrative process behind such a product and also received two Private Letter Rulings<sup>3</sup> that will apparently extend to all individuals who own this carrier's Letter Ruling approved product. Other carriers are apparently reluctant to attempt to replicate this result because they could be sued by the carriers with the patents for patent infringement, but the authors are aware of one other carrier who has recently come out with a similar product. It is fortunate for clients of the financial services industry that it is no longer lawful to patent new financial products under the America Invents Act that became effective September 16, 2011. This is discussed further in Chapter 13.

### **A Bird's Eye View of Professional and Potential Malpractice Liability Issues for the Legal and Accounting Practitioner**

David F. Sterling, Esq. is a lawyer practicing in Sarasota, Florida, and also a licensed insurance agent who from time-to-time places annuity contracts for investment clients. He is also a member of The Florida Bar IRA – Employee Benefits – Insurance Committee and the American Bar Association Section of Real Property, Trust and Estate Law. He gave us consent to publish the following Internal Memorandum, dated July 25, 2013, which provides important commentary and information for all professionals who operate in the annuity contract realm.

#### **INTERNAL MEMORANDUM**

**To:** FL Bar IRA – Employee Benefits – Insurance Committee Members  
**From:** David F. Sterling, Committee Member  
**Date:** July 25, 2013  
**Re:** A Work in Progress: The Annuity Review Checklist - Practice Management and Business Development Guide

I had been asked whether or not I could create an annuity review checklist or “cheat sheet” for Committee members. With some reluctance I indicated that I could. Of course, there would be some caveats, which include this first step submission.

It is a foregone conclusion that a “seismic shift” is taking place in the financial and estate planning arenas. The forces creating this “shift” are generally known to all and embrace every facet of the services we provide to clients. Suffice it to say that passage of recent tax legislation (ATRA 2012) “sealed the deal.”

No speculation is offered regarding the prospect of Washington changing course in mid-

<sup>3</sup> Private Letter Rulings 200305018, 200818018.

stream. However, it's better that we don't find ourselves up (someone's creek) without a paddle. It is no surprise to me, but may be to you, that even "fellow fins" are proclaiming the demise of an era while heralding a new arrival, which makes for an intriguing but disturbing prelude.

**PRELUDE** Estate planning is dead — Long live retirement planning!  
Nicholas P., MBA J.D. LL.M, ProducersWeb.com, July 17, 2013

**PREMISE** Estate planners need to be aware of the implications to their practices of the migration to financial products and strategies for owning products that lessen clients' interest or need to think about planning for probate, [estate taxes], trusts and "all that stuff."  
- Charles Ratner, National Director of Insurance for Ernst & Young Trust and Estates

**QUERY** As estate planning attorneys, we have the general duty to provide guidance and draft solutions to client questions regarding who gets what, when, why and how. **If you accept this proposition, how do you perform these services when your clients own or are considering the purchase of annuities?**

**CONSIDER** Annuities offer a compelling package of planning attributes and benefits.

Tax deferred earnings ___	Creditor protection ___
Guaranteed lifetime income ___	Beneficiary distribution planning ___
Probate avoidance ___	Long-term care expense coverage ___
Asset value preservation ___	Tax efficient cash flow management ___
Enhanced IRA performance ___	Medicaid eligibility planning ___

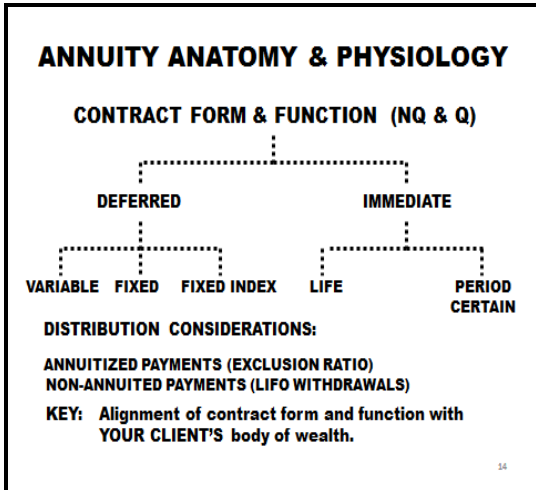
**Request. 1]** Check those items that fall within your purview and/or that you believe would have applications in the design of an estate plan. **2]** What observations or conclusions might you draw from this information?

**PERSPECTIVE** Passage of ATRA has enhanced the promotion, appeal and sale of annuities. As a tax and legal entity, the annuity possesses unique dispositive, distributive and transfer provisions. Consider these market and product implications:

- Annuities will continue to comprise a **greater portion** of asset and estate inventories.
- **Every sale results in a shift of estate assets.**
- Estimates of deferred annuity owners who die with their contracts left in force run **as high as 85-90%**.
- Trust ownership of annuities continues to be heavily promoted.
- **Annuities are promoted** as much for estate planning and wealth transfer attributes as they are for retirement planning purposes.
- Nearly **65% of sales** occur within retirement plans (qualified annuities).
- Sales figures indicate growing appeal among wealthy investors.
- Annuities are **complex legal contracts** with an array of company designed contingency default and reserved powers provisions.

- Annuity contracts do not operate on automatic pilot and do not come with user friendly operating manuals.
- With an estimated average **ownership age of 70**, contract issues and conflicts will accelerate with the increasing age and anticipated health declines of annuity owners.
- **Blended family** “ownership and designated beneficiary profiles” present unique planning, contract administration and settlement challenges.

**CONTEXT #1** Annuities come in array of body chassis, forms and functions as depicted below.

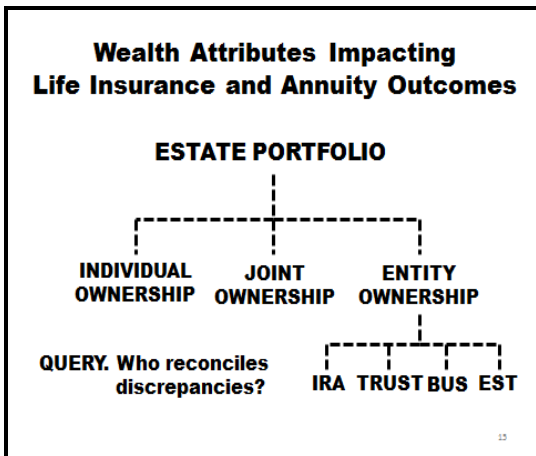


The annuity chassis comprises two basic structural components; (1) nonqualified contracts which are funded with after-tax dollars and (2) qualified contracts which are funded by and created through retirement plans; the most common being the IRA.

Next are the two basic annuity types; deferred and immediate annuities. These labels are self-explanatory. Deferred annuities “defer” payments until some future date while immediate annuities begin payments within one year of purchase. As noted, payments may be for life or elected (period certain) durations.

**Comment.** This slide presents an overview that will serve as a working foundation for understanding annuity contract design and operations. However, it does not include reference to a recent addition to the “deferred” category of annuities. The increasing promotion and sales of **contingent deferred annuities (CDA)** warrant your attention, which will be explained in a subsequent memorandum.

**CONTEXT #2** Clients own annuities within a framework comprising various tax and legal entities; all which have unique features and attributes impacting annuity contract functionality.

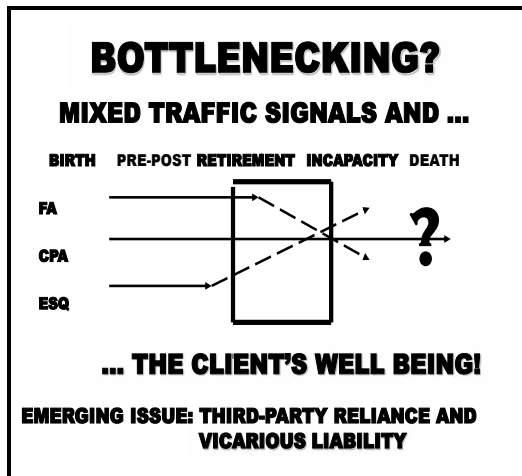


Here is the “dimension” to annuity contract analysis that elevates the advisory role and potential contributions of the attorney. It is one thing to demonstrate product knowledge and basic financial functions.

It is quite another to understand and articulate the implications of product features in the context and spectrum of clients’ wealth structures. **This is the domain over which the attorney rules.**

**Comment.** It seems that there are no “topics” off limits to the community of insurance agents and financial planners when discussing estate planning. Regardless of the potential exposure to regulatory sanctions, UPL allegations, civil penalties and even criminal prosecution, there continues to be little regard for the technical expertise and professional experience of attorneys. The label “deal killers” still resonates when the topic of “legal counsel” arises.

**CONTEXT #3** Life and evolving advisory relationships is a theme we are all familiar with, but may not acknowledge as often as we should. Business realities often intervene to disrupt and impede our best intentions.



**Bottlenecking.** As clients age, their needs become more complex and require greater professional expertise and counseling skills from advisors. The rectangular box captures a period in clients’ lives when confusion, chaos and conflict are the norm rather than the exception.

It also represents a period when advisor cooperation and collaboration should be the norm and not the exception. **Such is not the case in spite of frequent claims to the contrary.** What has been your experience?

**Comment.** The role of the attorney to ensure successful outcomes continues to be overlooked, minimized or blatantly disregarded by a significant portion of the financial community. When considering the long-term time horizons of insurance based solutions, it is not difficult to imagine the calamities and conflicts that would result if the governance structures (legal arrangements – i.e. trusts, durable powers of attorney and health care directives) were not in place to ensure the realization of policy benefits as our clients become increasingly encumbered by the effects of aging and health issues.

**CONFLICTS**

The task is to create a “user friendly” annuity review checklist or “cheat sheet” to facilitate the estate planning attorney’s review and evaluation of annuities owned or considered for purchase by the attorney’s clients. **Before proceeding with that assignment, there are a few practice management considerations which might come into play.**

**Malpractice Liability.** Practitioners are encouraged to review their policy provisions before rendering “financial or investment advice.” The following excerpt may offer some guidance. The language was taken from a policy sample acquired from a Florida based agency. My interview with the agency principal confirmed the company’s inclination to maintain a broad exclusionary bias.

**This policy does not cover any Claim:**

(r) arising out of the rendering, or failure to render, investment advice or the performance, or failure to perform, investment services, including the sale, purchase

or retaining of any investments, or any advice as to the sale, purchase or retaining of any investments.

**Weakening shield of “strict privity.”** Several RPPTL CLE programs have referenced the *Schneider* case and its relevance to estate planning professionals. This New York case has caused quite a stir and insurance products are in the purview, which bears directly on the importance of providing qualified, or at least, mindful counsel.

Though this represents a claim brought by the executor “standing in the shoes of the decedent” against the attorney for providing allegedly faulty advice regarding a life insurance transaction, it is not a “stretch” to otherwise envision the potential standing of contract beneficiaries for annuity transactions. Providing guidance for annuity trust funding and contract interpretation are examples that come to mind.

**Client disclosure regarding business associations.** The “conflict of interests” dimensions extend well beyond the following court’s assessment.

**It was incumbent on [the attorney]** to make sure that [his client] understood exactly what [the attorney’s] relationship with [the agent] was and how that relationship could affect the exercise of [the attorney’s] independent professional judgment.

**[The attorney’s] blind faith in [the agent]** - apparently arising from his reluctance to bite the hand that had fed him referrals - caused [the attorney] to be oblivious to major and fundamental derelictions by [the agent]. 2004 WL 5473926 (N.Y.A.D. 1 Dept.) (Appellate Brief) 787 N.Y.S.2d 309

**Query.** Might a client’s interests be compromised when the attorney identifies an “inappropriate” annuity sale conducted by an agent who refers considerable business to the attorney? **Note.** Unfortunately, this concern is more prevalent than you might imagine. My “case” file bears testimony.

**THE CLIENT  
ENGAGEMENT**

For those engaging in the annuity review process, the first consideration might be to determine the “nature” and “scope” of review activities and expected outcomes.

This determination is facilitated by targeting the location of the service along a continuum transitioning from purely financial to estate planning analysis.

This may be understood by identifying those activities and advisory considerations appropriate for financial advisors and agents compared with those more appropriate for legal counsel.

**REVIEW  
SCOPE**

Begin with this simple consideration. *Why enter terrain you are not expected or licensed to explore?* Each practitioner will make his or her own assessment, but this same consideration could be framed this way. *Why go to where you might not belong?*

**Setting the boundaries.** There are “elements” of the annuity contract review process

that can be distinguished by general financial and legal advisory criteria. This dichotomy is offered as a guide when considering your review of any insurance contract. I consider it crucial to managing client expectations and staying out of “harm’s way.”

**Financial**

1. Personal information, including the age and sex of the parties to the annuity and the ages and number of dependents;
2. Tax status of the consumer;
3. Investment objectives of the consumer;
4. The source of the funds to be used to purchase the annuity;
5. The applicant’s annual income;
6. Intended use of the annuity;
7. The applicant’s existing assets, including investment holdings;
8. The applicant’s liquid net worth and liquidity needs;
9. The applicant’s financial situation/needs;
10. The applicant’s risk tolerance and age;
11. Such other information used or considered to be relevant by the agent or insurer in making recommendations to the consumer regarding the purchase or

**Legal**

1. Intersection of these profile and data considerations with planning advisory and drafting solutions.
2. Incorporation of relevant data points with the tax and legal attributes and design elements of prepared entity arrangements – i.e. trusts, DPOAs, corporations and partnerships, divorce agreements, pre and post nuptial agreements, etc.
3. Applications of the financial profiling components to the unique features and limitations imposed by entity arrangements – i.e. total return trust provisions, general and specific powers of appointment, disclaimer elections, net income and/or discretionary powers of invasion, tax formula clauses, etc.
4. Impact on entity funding instructions and consideration of important planning options – i.e. portability and customized IRA beneficiary designations.

exchange of an annuity contract.

**Comment.** Not included in the list but also for consideration under the Financial category are annuity product features and functions. A 2-page exhibit has been attached to illustrate product characteristics. Caution should be exercised when venturing into explanations of product design and function as they pertain to annuity contract operations.

**Objective.** Establishing a framework for conducting a review of any insurance policy or other financial product should be created to manage and control “unintended” but otherwise “foreseeable” consequences. There are practice management traps for the unwary and overly confident.

Ultimately, the practitioner should define and limit the “engagement” to those considerations falling under his or her purview as they bear directly on legal duties and responsibilities to the client.

**CLIENT  
PROFILING/  
Q&A**

Before accepting a client relationship, many practitioners conduct an initial consultation, which may include the completion of a questionnaire that requests personal data, a description of special circumstances, family information and an overview of assets and current legal documents.

**PASSENGER PROFILES**

- BLENDED FAMILIES**
- ELDERLY COUPLES AND SINGLES**
- PRE AND POST RETIREES**
- TRUSTEES AND BENEFICIARIES**
- DPOA PRINCIPALS AND AGENTS**
- IRA OWNERS AND BENEFICIARIES**

**KEY: STATIONS IN LIFE AND DRIVERS OF  
CONTRACT DESIGNS AND OUTCOMES**

**Passenger Profiles** provides a broader context for evaluating the “suitability and consequences” of annuity transactions. Advisors tend to overlook or find it difficult to navigate the significance of various “client profiles” during the sales process. There exists a variety of governing circumstances and administrative imperatives that will impact the client’s ownership experience of insurance policies. Consider the importance of your role to design governance solutions.

**Comment.** Here is a productive technique for bringing estate planning into the “here and now” while showcasing your value proposition in a way I have rarely encountered. The discussion follows a general line of thinking when clients possess an annuity or any insurance policy as part of their estate inventory and financial resources.

- **Important.** The goal is to position the value you bring to the table and to encourage your prospect or client to engage your services. It is not to communicate or create a negative view about annuities. These policies can do great things when fully understood and properly applied.
  - **The reason(s) for owning the annuity(ies).** Remain patient with this and encourage speculation as specific reasons are often forgotten. Let the

dialogue wander where it wants to go.

- **The agent's explanation or rationale for his/her recommendation.** This is critical. It's often necessary to help the client with lapses in memory. Be sure to find out the name and business affiliation of the agent in a casual manner.
- **The workings of the contract.** Clients may experience some frustration with this item. Most clients cannot explain the workings of their annuity(ies). I doubt it will comfort the client to advise that he or she is in good company, as it is highly likely that the agent cannot do so.

**Contract understanding.** Here is an extremely effective "positioning" of the annuity during the review and analysis process. A technique I often use is to request that the client hand me their legal contract(s) so that I can scan a few key items. This sets the stage for a "fun" discussion that will bring you back to Contracts 101.

- **Note.** Clients have rarely, if ever, participated in any discussion about annuities as legal contracts. But, that is just what they are and it is a framework that will help clients understand what it means to own an annuity as a party to a contract. It is useful to have a client first offer his or her explanation or definition of contracts.

**Framing the close and subsequent steps.** There are a number of considerations that will enhance your role and value of your services. Here are a few.

- **Signing on the dotted line.** When you entered into the annuity contract, did you give any thought to who will administer the policy when you might be unable to do so?
- **Reading the contract.** This can be a tricky conversation, though I rarely "shy away." Did you happen to read the contract before signing? Would it concern you to learn that your agent probably did not read the contract before promoting and recommending its acquisition?
- **State and Federal Regulations.** Would it surprise you that there are no specific regulations that require an agent to actually read the contracts he or she promotes and recommends?
- **Annuities as unique tax, legal and financial instruments.** If the client can acknowledge the possession of this complex, difficult to understand and challenging to administer contract, that's half the battle.

If the practitioner can motivate the client to learn more about the implications of his or her ownership of the annuity, significant progress will follow. Here is where the psychology of "carrots and sticks" rather than "greed and fear" plays a key role, which, again, is attributable to the nature of contractually binding relationships.

Clients are accustomed to the negative approach demonstrated by many



professional advisors (accountants, money managers and attorneys) regarding the “evils” of annuities. Contract entitlements and “hidden” attributes or potential utilities are rarely considered. **Clients deserve an objective and fact based analysis from which to make informed decisions.**

**REQUEST &**

**FOLLOW-UP** The goal has been to provide a framework from which functional and practical annuity [and eventually other insurance product] review checklists can be created to serve the business interests of attorneys. By necessity, this includes protection from potential bar ethics and legal malpractice liabilities.

**The opportunities outweigh the risks of exploring what I consider to be a new and evolving niche practice area.** I could not help but be drawn to the conceptual embodiment of *financial jurisprudence*, which has its roots in Islamic tradition and law. The analogy is intriguing, though requires westernization.

**My request is simple.** I invite and welcome any commentary that Committee members are willing to submit regarding the advantages or disadvantages and desirability of continuing along this path to create an annuity review checklist with an accompanying practice management and business development guide.

Committee member insights and recommendations would enable me to assess the interest level, which might enable us to draw certain conclusions regarding the potential application of other insurance and financial product review checklists and business guides.

**If the interest is strong enough, a second memorandum will be created to address some of the following considerations.**

- The alignment and compatibility of specific annuity contracts with trust and estate document provisions.
- The use of annuities within retirement plans.
- Recent rulings and regulations impacting the application of annuities to the estate planning and document drafting process.
- Case law implicating the involvement and role of estate planning attorneys in annuity transactions.
- Annuity marketing and business developments of relevance to practitioners.
- Business relationships and strategic alliances with insurance agents who promote and sell annuities.
- Potential conflicts of interests.
- Any other suggestions Committee Members might be inclined to submit.

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David F. Sterling, Esq., Consultant  
2801 Fruitville Rd., Ste. 100  
Sarasota, FL 34237

Tel. (941) 366-6402 Int. [dfsterling@verizon.net](mailto:dfsterling@verizon.net) Fax. (941) 330-1966

## CHAPTER 3

### **15 REASONS TO BE CAUTIOUS ABOUT VARIABLE, INDEX,” “GUARANTEED INCOME,” AND SIMILAR ANNUITIES**

While vast amounts of literature exist expounding the virtues of annuities, it is important to remember that most of this is marketing material, paid for by sales agencies or insurance companies to promote their products. Such material tends to provide a less than comprehensive view of annuities, including the following limitations, obstacles and issues:

1. **Converting Long-Term Capital Gains into Ordinary Income.** With variable annuities you do not pay tax until the taxpayer takes the money out; however, eventually all gains will have to come out as ordinary income. Annuities convert long-term capital gains and dividends, which would be taxed at a maximum rate of 20%, into ordinary income, which is taxed at a maximum rate of 39.6%. Taxpayers who are subject to the 3.8% Medicare tax are looking at maximum payments of 23.8% on capital gains and dividend income, versus 43.4% on ordinary income. Individuals pay the Medicare tax on income exceeding \$200,000 if they are single, or \$250,000 if they are married and filing jointly.

A common scenario would be that a typical mutual fund worth \$100,000 might cause \$1,500 a year of long-term capital gains income and \$1,500 a year of dividend income, all taxed at the highest combined income tax and Medicare rate of 23.8%. Upon eventual sale of the mutual fund for \$200,000 after it doubles in value, there may be a \$98,500 capital gain taxed at the 23.8% bracket.

As the result of the above, the taxpayer might have paid taxes after 10 years of \$30,583 (10 years x \$1,500 x 23.8% of dividend income, 10 years x \$1,500 x 23.8% for capital gains income and a final capital gains tax of \$98,500 x 23.8%.)

Conversely, the same taxpayer might have no income tax in the first 10 years, and then a 43.4% combined income and Medicare tax on liquidation resulting in total taxes paid of \$42,749, but not until the tenth year.

Annuities may be best suited as a tax deferral device for high ordinary income investments like REITs ("Real Estate Investment Trusts"), and for hedge funds that throw off short-term capital gains which are taxed at the highest rate. The investor is in a higher tax bracket now than they are going to be when they retire, or when they retire, they may have horrendous nursing home expenses and they can take the money out and pay the nursing home expenses and get a wash deduction.

Converting long-term gains into ordinary income typically raises the tax rate for an investor's assets. Suppose you give an insurance company \$100,000. The company places the investment into clone accounts, mutual fund arrangements, and index arrangements. The company is going to give you a rate of return based on how the various funds perform. A mutual fund will typically receive dividend income and capital gains income, both of which are taxed between 15% and 23.8%. With a variable annuity, the good news is that you do not have to pay tax until you make a withdrawal or trigger income; the bad news is when you do have to pay taxes, it is at ordinary income rates. This bumps up the tax rate to 43.4% at most (including the Medicare tax), but there may be an extra 10% tax rate based upon an excise tax that applies in certain situations when distributions are made from variable annuities. Many investors are not aware of these increased tax rates.

Forbes Magazine recently cited a study by Richard Toolson (who is an Accounting Professor at Washington State University) that looked at the break-even points for variable annuities and investments in the same funds through a low-turnover stock index mutual fund in lieu of the annuity contract, based on the assumption that both investments earn the same pre-tax return. The study indicated that “an individual in the 36% income tax bracket *will never come out ahead by investing in a variable annuity* because of the continued drag of fees and tax issues related to the variable annuity product.”

In her 2012 Forbes Magazine article, “9 Reasons You Need To Avoid Variable Annuities”, Eve Kaplan states that, “If you truly want to convert after-tax dollars and gains to tax-deferred gains, you can pour money into a variable annuity but be aware you do NOT receive a tax deduction since annuities are not qualified retirement products.” Kaplan further explains that “Variable annuities convert lower capital gains rates on taxable income (if the annuity is purchased with after-tax dollars) into a higher tax rate levied on ordinary income. This can cost consumers significant tax dollars down the road.”

2. **No Step-Up In Basis on Death.** According to Investopedia.com a “step-up in basis” is: “the readjustment of the value of an appreciated asset for tax purposes upon inheritance. In most cases, when an asset is passed on to a beneficiary, its value is more than what it was when the original owner acquired it. The asset therefore receives a step-up in basis so that the beneficiary’s capital gains tax is minimized - because it is not based on the increase in value from the original purchase price.”

Annuities do not receive a step-up in basis when the owner dies—the income has to come out eventually and will be taxed at ordinary rates. Annuities (and IRAs and other qualified plans) are treated as “income in respect to decedent” upon the death of the owner under the tax law, which essentially means that there is built up income earned during the lifetime of the decedent which must be paid out at ordinary income rates after the decedent’s death.

For example, if an investor owns an annuity with an \$80,000 cost and a \$200,000 value, and he/she dies, then his/her family is going to eventually pay tax on that \$120,000 of gain when they pull the funds out. There is absolutely no way around this unless the investor has net operating losses or huge nursing care costs in his or her later years, so that they have losses to offset the ordinary income. This is important to keep in mind.

Eve Kaplan also addresses this issue, noting that “annuities are disadvantageous to inherit if they don’t go to a spouse. If the money formerly was after-tax dollars, the heir receives no step-up in basis on accounts with gains. If you invest the same dollars (after-tax) in a stock fund, your heirs benefit from a step-up on basis at the date of death or 6 months later. This is hard to quantify but a step-up in basis is a powerful tool to reduce capital gains taxes.”

3. **Guarantees are Complicated and Often Deceiving.** Most commercial annuities with “guaranteed income” or “market protection” features are extremely complicated and difficult to understand. The sales materials for these products may be confusing at best and intentionally misleading at worst. In many cases, even the salespeople for annuity products do not seem to have a firm grasp on the purpose or the financial mechanics of the product. Most elderly investors have no hope of truly understanding how the products work, and illustrations only serve to further muddy the waters. The guarantees in annuities are complicated and they may even be deceiving.

As John Prizer, Jr., CFP, CFA, of Simple Financial Solutions in Maitland, Florida, put it: "If you analyze an annuity with a guarantee feature and reach the conclusion that a majority of the policy owners can expect to come out ahead, you do not understand the product because that cannot be so. It is, however, theoretically possible that an annuity contract could be constructed with a guarantee that would increase the probability of achieving certain goals." What John means is that life insurance companies are in the business of making money, so they design policy fees that are taken out of the contracts each year to well exceed the cost of any guarantees or other arrangements. Guarantee features are designed to preserve value in the annuity product in the event of a significant market downturn, but the cost of such guarantee features makes it difficult for the product to come out much ahead if the market otherwise increases or stays relatively stagnant.

While some life insurance policies will probably lose money because of these guarantees, this is not good news for the policy owners, because the guarantees could cause the annuity companies to fail and not be able to pay the policyholders anything more than the actual investments sold under the contract.

In 2008, a number of life insurance companies had to apply for and receive part TARP money, and presumably would have failed or have come close to failing, which would have left policyholders with a horrendous situation.

Some very well written and documented blog posts by investment expert, author and lecturer Michael Kitces, were posted on August 28, 2013 and November 20, 2013 in the Nerd's Eye View blog. Mr. Kitces has confirmed for the author that the content of these very well written posts are still pertinent.

**Do Today's Guaranteed Living Benefit Annuity Riders Really Offer Enough to be Worthwhile?  
By: Michael Kitces, Posted Wednesday, August 28, 2013**

The fundamental promise of guaranteed living benefit riders on annuities is the potential to invest more aggressively for growth, while maintaining an income guarantee no matter what, in case things don't work out as expected. In other words, at the most basic level, using income guarantees is a "floor with upside" approach to investing for retirement income. The floor may not be the most appealing income level, but it's tolerable on the downside when there's a hope and real chance that things could turn out much better.

Yet in today's environment, the combination of lower prospective returns and higher annuity costs is presenting a troubling new alternative: that guaranteed income riders no longer representative a "floor with upside" but instead are a floor that will be almost impossible not to fall down to and hit. In other words, what was supposed to be a floor that would only be relied upon in a worst case scenario may instead turn out to be the best case scenario and an unavoidable outcome instead!

Unfortunately, though, if the reality is that the income guarantee of the annuity is no longer a worst case scenario but actually a best case one, then it no longer represents the fundamental trade-off that made it so attractive in the first place. Instead, if there really is little upside to the income guarantee, then it may be more appealing to skip the guaranteed living benefit rider altogether and instead just buy a single premium immediate annuity for a comparable guarantee and invest the rest, or just invest and spend conservatively using a safe withdrawal rate approach and simply ride out any intervening market volatility!

## **Understanding The Guaranteed Living Benefit Rider**

The guaranteed living benefit rider, first associated with variable annuities and more recently with equity-indexed annuities, was first created in the late 1990s and rose dramatically in popularity in the early 2000s after the technology crash. The basic concept of the riders was relatively straightforward: for a modest fee, the client could remain invested as he/she wished, but be assured of a minimum "benefit base" that would grow over time and could be converted into income via either withdrawals or annuitization. At best, the cash value would grow favorably with returns, but at worst, at least the income guarantee would be available to fall back on.

Thus, for instance, if the client put \$300,000 into a variable annuity with a living benefit rider, then an amount equal to \$300,000 growing by 5% per year could be withdrawn against or annuitized in the future (depending on the terms of the contract), and in the meantime the assets would remain invested and grow (or not) based on whatever the market delivered. If market returns were good, the client could walk away with the cash value plus growth (minus the cost of the guarantee itself, which often was a fairly modest 0.25% - 0.50% {in addition to other applicable annuity and investment charges}). If the markets crashed, the benefit base amount would be available to generate retirement income. Heads and the client could win, tails and the client would at least not lose as much, which was a reasonable win-win outcome.

Of course, the terms of the guaranteed retirement income from such riders were not great. Often they included age setback provisions, unfavorable mortality tables, and were built upon very low internal rate of return assumptions. Many provided withdrawal guarantees that ultimately amounted to little more than the client spending their own money for 15-20+ years before the annuity company was ever actually on the hook for anything. But as a worst-case-scenario floor, at least it was something, especially since ultimately the goal and intention was to do far better than the income guarantees anyway; the guarantees were only there as a last resort, just in case.

## **Living Benefit Riders In Today's Environment**

So what's changed in today's environment? There are three factors that have changed together in recent years, which all make the risk/reward trade-offs of living benefit riders far less appealing than they once were.

First of all, the raw costs of living benefit riders themselves have increased; as volatility rose in the years after the financial crisis, and many companies realized they needed to charge more simply to safely back the guarantees they were providing, what was once a 0.25% - 0.50% rider guarantee now often costs 0.75% to 1.25%. Often riders that have a lower price have the option to increase it to a higher level at the discretion of the company (sometimes as far as 1.50% to 2.50%), which unfortunately may be an all-too-probable outcome if the markets crash and the rider really needs to be relied upon (although in fact, some companies have already been raising the fees on existing riders, even though markets have been trending higher). And of course, that's in addition to the raw M&E cost of the annuity itself, and the expense ratios of the underlying annuity subaccounts, which can bring the total cost up anywhere from 2% to 4% depending on the details of the contract.

Second, today's investment environment has a lower expected return over at least the intermediate term environment, which limits the potential for upside in the first place. With bond yields at levels that are several hundred basis points below typical long-term returns, intermediate real TIPS yields at near-zero or even negative levels, and long-term (Shiller) P/E ratios at elevated levels that are typically associated with depressed 10-year real returns, the expected return for today's portfolios are well below average in the coming years, potentially no more than the mid-single-digits for a balanced

portfolio. This is especially problematic if ongoing withdrawals are occurring. If the retiree is taking out 5% annual withdrawals, and dragging a 3% total expense for the cost of guarantees plus the cost of the annuity plus the cost of the investments themselves, it may be almost impossible for growth to exceed the drag of withdrawals and costs before reaching the point of inevitable depletion.

Of course, investors can try to leave room for greater upside by investing more aggressively in a portfolio that at least has a possibility of out-earning 5% annual withdrawals and a 3%-ish cost drag. However, this too is no longer an option, as the third change in today's annuity contracts is that they are increasingly limiting investment choices to require diversified portfolios. In other words, most annuity contracts will require the policyowner to have as much as 40% of the contract invested in low-return fixed income investments where the annuity costs alone (never mind including withdrawals) exceed the expected return. With such a severe drag on the portfolio it's virtually impossible to have a sufficient amount invested aggressively enough to produce any real upside potential. After all, if 40% of the assets are generating no return (or a negative return after fees), then the remaining 60% of the portfolio must generate the growth for all of it; if 5% annual withdrawals are coming out, the remainder of the portfolio must generate an 8.3% net return just to avoid a path to assured depletion, which is actually a whopping 11.3% gross return before fees, which is at best very difficult to achieve in today's environment and unlikely to be achieved reliably.

### **Alternatives With Similar Floors and Greater Upside?**

Given that such high equity returns are probably unrealistic in today's environment (after all, 11.3% gross returns are even higher than the overall long-term average, not to mention from an above-average-valuation starting point!), what are the alternatives?

The first is simply to spend more conservatively and stay invested with a lower cost portfolio; in other words, to utilize a safe withdrawal rate strategy (which is essentially a floor-with-upside approach) that deliberately sets spending low enough to ride out the market volatility. While following a 4% safe withdrawal rate approach may seem unappealing when an annuity income guarantee might offer 5%, it's crucial to remember that safe withdrawal rates assume inflation-adjusted spending, while living benefit riders generally only provide level cash flows that may be eroded by inflation over time. Which means that while a safe withdrawal rate approach might mean spending \$40,000 from a \$1M portfolio initially, the spending is assumed to have risen to nearly \$100,000 per year by the end (with a 3% inflation rate for 30 years), while the annuity guarantee will still be paying only \$50,000 at the beginning and the end (while many annuities do have income guarantees that step up with market growth, remember that with 5% withdrawals and 3% costs and a low-return environment, the odds are not good that the income guarantee will ever materially rise with the market over time). Ultimately, then, the annuity approach generates \$1.5M of cash flow for 30 years, while the safe withdrawal rate generates nearly \$2M of rising cash flow (albeit from a slightly lower starting point); and the safe withdrawal rate approach also has far more upside potential to boot, as it's not dragging such hefty fees. In fact, one might wonder why it's worthwhile to pay for the annuity guarantee at all when it merely provides a series of cash flows that are almost 1/3rd less than was ever necessary even in the worst historical market return scenarios we've ever had! In other words, what's the point of paying for a guarantee that ensures less than what can be had by merely being conservative? The point of a guarantee should be to get a higher floor in exchange for conceding some upside, not to reinforce a floor that's even lower than what was already feasible without a guarantee!

Of course, one key distinction is that safe withdrawal rates are assumed for a 30-year time horizon, while at least some income guarantees from annuities are for life, however long that may be. In other words, the annuity also provides a longevity hedge at whatever income floor it offers, while a safe withdrawal rate approach is based on a time horizon the client at least might outlive. Yet if the goal is

simply to secure an amount like \$50,000/year (5% of a \$1,000,000 portfolio) as a lifetime income and still have upside, the reality is that the retiree can simply buy a single premium immediate annuity to accomplish that goal! For instance, even at today's rates on ImmediateAnnuities.com, a 65-year-old couple can buy \$50,000/year for life for \$839,990 (or only \$727,377 or \$764,391 for a single male or female, respectively). This leaves the remaining ~\$160,010 (or more) available to invest or to hold in reserves, without the cost drag of the annuity. In other words, if the reality is that a \$1,000,000 variable annuity with a living benefit rider provides a guaranteed \$50,000/year for life, but will have little or no upside in today's environment due to the combination of higher costs and lower returns, why not secure that same goal with only \$839,990 (or less as rates rise) and leave the rest of the money invested elsewhere to produce a more feasible upside?

Understandably though, many investors don't want to give up so much liquidity in a SPIA, and still aren't necessarily comfortable with the approach of just being conservative and riding out market volatility, and really want guarantees. Yet the challenge is that using an annuity with guarantees doesn't necessarily eliminate the risk, it simply shifts it - and potentially concentrates it - with the annuity company. After all, unlike immediate lifetime annuities that manage mortality risk by pooling together a large number of people so those who die young can help fund mortality credits for those who live long, with variable annuity living benefit riders a market decline forces the annuity company to set aside reserves to potentially pay guarantees for everyone at once. In turn, this can make the reserve demands and profitability of the annuity company more volatile, as was witnessed in 2008-2009. In fact, it's notable that while diversified investors have already recovered to new highs since the financial crisis, many annuity companies providing guarantees have permanently left the business after the financial crisis and are even trying to reduce their exposure to (and entirely get off the hook for!) their existing annuity guarantees. In other words, while the annuity guarantees were supposed to pool retirement assets and risk management together to protect retirees better than just being a diversified low-cost investor, the reality is that it was the standalone investors who came through with a quick recovery and some annuity companies that took a knock-out punch!

Furthermore, given the pain that the last bear market brought to companies providing retirement income guarantees, many of the guarantees shifted to contracts where the annuity company has more control: i.e., equity-indexed annuities. The upside for the annuity company of using equity-indexed annuities is that it's far easier to manage the costs of the guarantee when the company controls all the money that underlies the guarantee, and has the flexibility to set participation rates, cap rates, and spreads at levels that ensure the product will be viable. While that's not necessarily a bad thing - if the company offers genuinely competitive rates - the risk is that if another market event occurs, the insurance companies will simply reduce the participation rates, caps, and spreads at that time, and annuity owners will have little recourse (as surrendering the annuity to reinvest for better returns at that point would forfeit the guarantees that were being purchased). In other words, it doesn't matter if the company guarantees its costs if it also controls the money invested and has the right to dictate whether (or not) the policy will pay an appealing rate of return. This is ultimately the key concern for any equity-indexed annuity - similar to hybrid long-term care policies; it's easier for companies to offer more appealing guarantees when they have the control and capability to cut the rates of return paid to policyowners to make up for any shortfall! In fact, given that equity-indexed annuity policies already have less upside, simply by virtue of their inherent risk/return trade-offs, it appears increasingly likely that many equity-indexed annuities are destined for the same "no realistic upside" scenario as today's variable annuities with living benefit riders. On the other hand, as Moshe Milevsky recently noted, the raw annuitization payout rates on some equity-indexed annuity guaranteed living benefit riders are remarkably competitive to today's SPIA rates anyway, which suggests there may be little downside to at least taking a shot at risk-managed upside before annuitizing (if annuitization is already the plan), at least for assets that were going to be held in cash or invested for little or no return anyway.

Ultimately, though, the fundamental point to all of this is that the purpose of annuities with living benefit riders is to provide a guaranteed income floor, while also being able to invest for (and have a realistic chance of achieving!) upside growth. In the early days of guaranteed living benefit riders, this is exactly what the contracts delivered, allowing investors to put a floor under their portfolios (or better yet, under the most aggressive subset of investments in their portfolios) at a more modest cost, and without being required to drag a large portion of the portfolio in low-return investments that cannot outearn the cost of the guarantees wrapped around them. Accordingly, clients should still be very cautious about surrendering any existing annuities without a thorough due diligence process. But in today's environment, as insurance companies require investors to hold a portion of assets inside the annuity in less productive investments, and at a higher cost, and in a lower return environment, the trade-off is simply not what it once was. Suddenly, saving the cost and just investing and spending conservatively appears to be a remarkably appealing alternative.

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Michael E. Kitces, MSFS, MTAX, CFP, CLU, ChFC, RHU, REBC, CASL  
Pinnacle Advisory Group, Inc.  
6345 Woodside Court, Suite 100  
Columbia, Maryland 21046  
Tel. (410) 995-6630 michael@kitces.com Fax. (410) 505-0960

**Can Variable Annuities Really Offer Insurance Guarantees Against a Market Catastrophe?  
By: Michael Kitces, Posted on Wednesday, November 20, 2013**

Since the tech crash, it has been increasingly popular to purchase variable annuities with "guaranteed living benefit" riders to help protect retirement income against the risk of a market catastrophe. The basic premise of the contracts is rather straightforward: for a modest cost, the insured can transfer the risk of a severe market decline to the insurance company, and remain assured that guaranteed retirement income will be available for life, undiminished by the market decline. In the meantime, the annuity owner has the opportunity to stay invested in the market, with the hopes of generating an ever greater upside (albeit reduced by the costs of the annuity).

The problem, however, is that unlike most types of insurance - where the law of large numbers allows the insurance company to have relative certainty about the timing and magnitude of potential claims - in the case of annuities with income guarantees against a market decline, the insurance company faces virtually no risk exposure for any of its policyowners, until a major market decline actually occurs... and then, suddenly, the insurance company must set aside reserves for everyone, all at once. The end result is that market volatility can end out creating drastic volatility in the required reserves and profitability of the insurance company - to such an extent that in the past several years, many major insurers have decided to stop offering the guarantees altogether.

In the aggregate, the problem is that having a large group of prospective policyowners transfer their exposure to market risk to the insurance company may seem like the risk is being transferred from the policyowner's perspective, but the risk is actually being concentrated from the insurance company's perspective, in a remarkably undiversified manner. As a result, the policyowners actually face the danger of turning what was a systemic risk exposure to overall markets into a very specific, undiversified, unsystematic risk exposure to the credit quality of a particular (insurance) company instead. And for those who fear the danger of a "black swan" event, the reality suddenly becomes clear that the kinds of black swans that could be a blow to markets may actually be an even more severe blow to the insurance companies trying to guarantee against them, as was evidenced by the need of at least one annuity provider to access Federal TARP funds for liquidity in the immediate aftermath of the financial crisis.



Ironically, it turns out the best alternative may simply be the solution that advisors recommended before such annuity contracts were available in the first place: to invest more conservatively, and spend more conservatively, and simply stay the course and weather the storm. After all, conservative spenders following a safe withdrawal rate approach have largely recovered their declines since the financial crisis, while many insurance companies have left for good; similarly, while the safe withdrawal rate weathered the Great Depression, many insurance companies did not. Of course, in today's marketplace, the annuity companies have finally figured out how to properly structure, constrain, and price annuity guarantees to manage their risk exposures and make the products economically feasible to be offered; yet the outcome of such pricing may be leading to the point where their floor-with-upside guarantees are no longer an appealing trade-off for the (new) cost.

### **Fundamentals of Insurance**

The basic principle of insurance is very straightforward. Individuals pay premiums into a common pool of money with an insurance company, which the company invests for some growth (and subtracts a bit of cost for the overhead of the insurance company), and then uses a combination of the original premiums plus growth to pay out insurance claims. To the extent there's money left over (claims are less than the premiums plus growth), the insurance company generates a profit, while if the claims exceed the premiums plus growth, the insurance company has a loss. Since insurance companies are a going concern, with a steady stream of new premiums coming in, claims being paid out, new policies being established, and old policies that are allowed to lapse, the ongoing management of the insurance company is a bit more complex, but the fundamental equation remains the same: premiums + growth - costs = claims + profit margin. The insurance company sets the premiums, manages the costs, invests for growth, and aims for a certain profit margin that will be left after anticipated claims.

Of course, this also means that being able to effectively anticipate claims is absolutely crucial for the effective function of a life insurance company, which is no small feat in a world where any individual insurance claim - from the death under a life insurance policy to a fire burning down the house under a homeowner's policy - can seem exceeding random on a case by case basis. Fortunately, though, what we see from the "law of large numbers" is that, given a large enough sample size, the actual number of incidents average amount remarkably close to the expected value (assuming, for the time being, we can make a reasonable estimate of the expected value in the first place). What is "random" at the individual level is remarkably stable in the aggregate.

Thus, for instance, while in any individual scenario, the person does or doesn't die and the house does or doesn't burn down - a very random, binary outcome - with a large pool of insured individuals (or properties), the frequency of claims becomes remarkably consistent, allowing the insurance company to be able to set an effective premium that allows the whole mechanism to work in the first place. In turn, this allows for the availability of everything from life insurance to homeowner's insurance; for some newer types of insurance coverage, we may not get the expected value right initially - such was the case early on for disability insurance, and more recently for long-term care insurance - but the principle remains the same: in large numbers, claims can occur with relative consistency.

Of course, with enough consistency, the outcome is essentially an assured loss for any individual insurance policy owner; on average, the policyowner's expected value is reduced by the costs (and profit margin) of the insurer. But access to insurance allows the individual to turn what could be a relatively extreme financial impact - like the loss of a family's primary breadwinner or the house that they live in - into a much smaller, manageable cost. While technically the expected value of the insurance transaction is financially diminished by insurance company overhead and profit margins, it

provides a way for an individual facing a binary outcome - the event does or doesn't happen - to participate in the much steadier law-of-large-numbers outcomes instead.

### **Insuring Against a Market Catastrophe**

While insurance can be a highly effective way to manage risks that are highly uncertain individually but average out effectively in large numbers, the problem with trying to insure against a market catastrophe is that the risks don't "average out" over time; instead, they clump together. After all, the reality is that if a large number of people buy insurance against a market decline - e.g., through a variable annuity with a living benefit rider (GMWB, GMIB, etc.) - then nobody will have a potential insurance claim while the market is going up, but virtually everybody will be "in the money" at the same time when there's a severe bear market.

Of course, insurance companies had some acknowledgement of this risk, which is why policies that "insured" against market declines did not pay out an immediately liquid benefit, but instead merely allowed the policyowners to draw out lifetime income which meant, at some point, they may eventually deplete their own assets and then draw on the insurance company's guarantee. Nonetheless, when a severe market decline occurs, regulators require the insurance company to ensure it has reserves sufficient to pay out on its potential obligations, requiring a huge allocation to be set aside; thus, while the insurance company may ultimately be able to make good on its guarantees, avoiding a knockout punch default, the impact to profits for the reserve allocation is so severe the "technical" knockout punch leads the insurer to leave the business anyway (as occurred with several annuity guarantee providers after the financial crisis).

The challenge is compounded by the fact that, given market volatility, the sufficiency of reserves to back market guarantees themselves become highly volatile, as a base of hundreds of billions of dollars of assets are backed by guarantees funded by fairly tiny (relative to the assets) rider fees. If there is an extended bull market - and the insurer has many years to collect fees before facing a market decline that results in a significant insurance exposure - the consequences can be somewhat more contained. But the fundamental problem remains that - unlike virtually all other types of insurance - it's not feasible to slowly, steadily build reserves against a slowly, steadily rising base of guarantees; instead, because all the contracts are tied to the same underlying stock market risk, virtually all the policies become a potential claim at the same time. For instance, if \$300B of guaranteed annuities experience a severe 25% market decline, the insurance company is suddenly exposed to as much as \$75B of claims, for which gathering a 0.5%-of-\$300B - which is "only" \$1.5B of fees - just doesn't cut it.

Notably, in other insurance contexts, companies are very cautious not to back risks that could result in a mass number of claims all at once. This is the reason why most insurance policies have exclusions for terrorist attacks and war, and similarly why it's so difficult to get flood insurance in many parts of the country (and/or why the government must often make flood coverage available as the insurer of last resort). It's a crucial aspect of insurance that in the end, its exposure to risk is well diversified (allowing the law of large numbers to work) and not be overly concentrated.

### **Diversifying Risk or Concentrating It?**

Ironically, while consumers view insurance company guarantees as a way to diversify their exposure to risk, the truth is that they are actually transferring their risk to the insurance company, and in the process the insurance company is actually concentrating the risk, given that a market decline can put virtually all guaranteed contracts "in the money" at once. Thus, as seen in the financial crisis, while many investors could afford the market decline and stay invested for the recovery (as the market has

now reached new highs), the concentration of those risks aggregated in some insurance companies was so severe that they've discontinued the products altogether (and in one case, actually need a "bailout" loan from the Federal TARP funds!). And unfortunately for the insurance companies, the problem seems to have been exacerbated by investors who bailed out of markets (but not the annuity guarantees), effectively "locking in" their losses and virtually ensuring that they will eventually become claims against the insurance company (and of course, with the policies "in the money" few people are surrendering or lapsing them anymore, either!).

In the aggregate, these challenges raise the question of whether investors can really protect against stock market "black swans" by buying insurance, or whether attempts to do so just converts the black swan from an investor risk to an insurance company risk (and a more concentrated one at that). Bear in mind, the fundamental purpose of insurance is not to make people whole from their losses in the aggregate; it's to redistribute and smooth the losses by turning large impactful risks into smaller, manageable ones by sharing some of excess premiums of the "winners" with those who have claims (the "losers"). Except when the risk strikes all policyholders at the same time - as is effectively the case when insuring against market declines and economic catastrophes - then the insurance company simply doesn't have the resources to make the protection work, as there are no "winners" to offset against the "losers" in such scenarios. Instead, none of the policyholders are actually drawing against the insurance company's risk pool and reserves against a market catastrophe... until they are, together, all at once.

The bottom line is that, ultimately, people seek out insurance guarantees to protect against "untenable" risks in the markets. The kinds of "black swans" that can result in an economic disaster and a market catastrophe. Yet the reality is that when such extreme events occur, the insurance companies that ultimately use the same capital markets find themselves exposed to the same systemic risks and events. Clients might seek out a variable annuity guarantee to protect against the next Great Depression, yet the reality is that there were a non-trivial number of insurance companies that failed in the last Great Depression (not to mention the long-forgotten "Insurance Holidays" instituted to protect more insurance companies from default!)! Yes, it's true that we regulate insurance companies better now than we did back then, but by definition "black swans" are events that aren't predictable, can't be foreseen, and therefore can't necessarily be regulated against in advance.

This doesn't necessarily mean that a random black swan is likely to come along and wipe out a large number of insurance companies, but the point remains that if the fear is that a black swan could be coming, an insurance company isn't necessarily a safe place to hide. In fact, the client risks turning a systemic risk for their overall portfolio into a more concentrated, less diversified individual risk into a single company (since, in the end, a guarantee is only as good as the credit quality of the individual company underwriting the guarantee, which isn't exactly "secure" if you're assuming a black swan economic catastrophe up front!). Yes, there are also state guaranty funds, but it's not clear they're remotely well-capitalized enough to bail out the insurance industry in the aggregate (not to mention that most states limit their annuity guarantees), and does anyone really want to bet whether deficit-strapped the states can/will come up with the additional state-guaranty-bailout-funds if called upon?

### **Where To Go From Here?**

So what's the alternative, for investors and clients who really want to do something to manage their exposures to risk?

Simply put, there are two primary alternatives: 1) to just not take as much risk in the first place, managing risk not by trying to shift market risk to an insurance company, but just owning less risky stuff in the first place (i.e., having a more conservative portfolio); or 2) by simply spending

conservatively enough that even if "bad stuff" happens in the portfolio, the retiree who in the end is only spending a few percent a year from the portfolio allow can allow the bulk of the assets to stay invested long enough for a recovery to occur.

After all, it's quite notable that in the end, this kind of safe withdrawal rate approach survived a Great Depression that many insurance companies did not, and those following a safe withdrawal rate approach since 2008 are doing fine (given the stupendous market rally that has occurred since the decline) while a large number of insurance companies had to permanently exit the marketplace. In other words, notwithstanding how scary the ride can be at the time, the reality seems to be that just prudently managing a portfolio and drawing a conservative amount from it each year has had more success withstanding bear markets, economic turmoil, and "black swans" than the insurance companies some investors are looking to for protection. To be fair, not all insurance companies have left the business since 2008, and none have actually outright defaulted on their guarantees at this point. But we have seen a number of very consumer-unfriendly practices from insurance companies trying to get off the hook for their guarantees, from "buy-backs" to changing available investment options and constraining asset allocations and more, and we still don't know how the next bear market will play out either.

Notably, this doesn't mean that advisors and their clients should eschew annuities and their guarantees altogether. The term "annuity" is still used to label an incredibly broad range of products, and some do not face these "concentration" risks at all, whether it's plain vanilla variable annuities used as a tax-deferral and asset location wrapper, fixed annuities that may have an appealing yield, or an immediate annuity that pools mortality/longevity risk (which really does obey the law of large numbers!). Nonetheless, when it comes to offerings like variable annuities with guarantees against market risk, it remains unclear whether in the end, clients are really shifting their systemic market risk away, or actually concentrating it into an even more dangerous unsystematic specific-company risk instead! That's not diversification, it's concentration!

Fortunately, many annuity companies have at least recognized the tenuous situation of their current market guarantees, leading to contracts that have less generous benefits, higher costs (or at least, costs that the insurance company is permitted to raise significantly in the future under the contractual provisions of the annuity), and "indirect" costs like asset allocation requirements that force investors to hold a significant portion of assets in fixed income investments that may cost more than their prospective return. Which means the danger of an annuity company "catastrophe" is perhaps diminished, but at the cost that it's no longer clear whether there's any value in using an annuity to secure an "income floor with upside" when there may no longer be any upside in the first place after the embedded costs.

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Michael E. Kitces, MSFS, MTAX, CFP, CLU, ChFC, RHU, REBC, CASL  
Pinnacle Advisory Group, Inc.  
6345 Woodside Court, Suite 100  
Columbia, Maryland 21046  
Tel. (410) 995-6630 michael@kitces.com Fax. (410) 505-0960

4. **10% Excise Tax.** A 10% excise tax on built-up income will apply when withdrawals come out to any individual (or possibly a trust) who has not reached age 59 ½. Therefore, for taxpayers in the highest bracket, their marginal tax rate with respect to such withdrawals is not 39.6% -- it is 49.6%. The 10% excise tax will apply on funds withdrawn from an annuity to the extent that there is income under the annuity.

The excise tax may apply to trusts for generation skipping or creditor protection, even where the monies will eventually make their way to beneficiaries who have reached age 59 ½.

Further, making annuities payable directly to individuals can open wealth up to mismanagement, divorce exposure, and other issues.

5. **Must Pay Out Ordinary Income Shortly After Death Unless Payable to the Spouse or the Synthesized Variable Annuity Arrangement Described in Chapter 12 is Available.** Although the Internal Revenue Code has rules for non-qualified annuities similar to the "stretch IRA" minimum distribution rules that apply where trusts are the holders or the beneficiaries of qualified retirement plans, the IRS has never issued regulations or other guidance on this topic for non-qualified annuities, so most carriers will not allow annuities to continue in trust after the death of the policyholder or annuitant. Therefore, funding of irrevocable credit shelter trusts and/or generation-skipping exempt trusts with variable annuities will normally not work.

When somebody dies owning an annuity, Congress is essentially requiring taxpayers to take monies out of the annuity and pay tax on the built-up gains in a manner similar to IRAs and other retirement plans. But unlike IRAs and pensions, which have very complicated but manageable rules allowing taxpayers to make IRAs and other retirement accounts payable to trusts (which in turn make distributions over the life expectancy of the beneficiary to the trust), non-qualified annuity contracts are not afforded the same treatment. With non-qualified annuities, the contract will not qualify for tax deferral unless it provides that on the death of the holder, if the beneficiary is not the spouse, it has to come out within 5 years or over the lifetime of the individual beneficiary.

Internal Revenue Code Section 72(s) provides the general requirements that a contract must satisfy in order to be treated as an annuity contract for income tax purposes (and therefore be afforded tax deferral advantages). If a contract does not satisfy these requirements, then all payments received under the contract after the holder's death will be included as gross income to the extent of the appreciation or built-up income in the annuity.

The taxation of annuity contracts is discussed in more detail above in Chapter 3 and later in Chapter 7 of this book.

6. **Estate Tax Planning With Discounts Is Made Difficult.** Discounting values for estate and gift tax purposes normally involves placing investments in family limited partnerships, limited liability companies, and similar arrangements to facilitate partial interest gifting and "discount on death" planning where individuals will have estates exceeding the \$5,340,000 allowance, or have made large gifts during their lifetime, and have assets exceeding what the reduced exemption allowance will be as a result of those gifts. The valuation discount phenomenon results from the idea that the value of a minority interest or non-voting interest in a limited liability company or limited partnership is worth less than its percentage share of the net value of the underlying assets of the entity due to the minority interest or non-voting interest not being readily marketable (i.e., it is not easy or even possible to sell this on the open market, and such interest not having the ability to liquidate the entity or to control the entity's business).

A business entity that is separate from its owner, but elects to be disregarded as separate from the business owner for federal tax purposes, is a "disregarded entity." According to the IRS, "if a 'disregarded entity' is owned by an individual, it is treated as a sole proprietor. If the 'disregarded entity' is owned by any other entity, it is treated as a branch or division of its owner."

While it would make sense that an annuity contract could be held by a "disregarded entity" with special design and drafting, most carriers will consider the transfer of a product to a family limited partnership or limited liability company as a taxable transfer, and will issue a Form 1099 as if the contract proceeds were paid out. Also, it is not clear what happens if a taxpayer "compresses" the value of a variable annuity under a discount vehicle like a family limited partnership or a limited liability company.

As an example, the authors had a client who was very ill, and her net estate was approximately \$7 million. Much of her estate was invested in variable annuities. The client had an LLC and the authors wanted to place the annuities into the LLC to protect them for a number of reasons, one of which was to obtain discounts for estate tax purposes. Typically the transfer of an annuity from a person to a partnership or an LLC will trigger all of the built-up income in the annuity contract, but a limited liability company or a family limited partnership can be structured to be disregarded for income tax purposes and treated as owned by the individual. The authors put together all of the paperwork to facilitate this, but when they went to register the change of ownership of the annuity contract to the disregarded LLC, the carrier called and recommended against the authors doing this because the carrier would have to issue a Form 1099 for all of the income in the annuity if such paperwork was filed. The authors responded that this should not be an issue because the LLC is a disregarded entity that is considered as owned by the client for federal income tax purposes. However, the carrier responded by saying that they do not have any Private Letter Rulings and have not been able to get the IRS to recognize disregarded entities for the purposes of triggering all of the income built-up inside the contract. The carrier also said that the authors were probably right, but that they would nevertheless have to issue a Form 1099 to report all of the built-up gain under the contract as having been distributed, which could cause an income tax audit. As a result of this problem, we had to find another solution to help this client out. The family ended up liquidating the annuity contracts and paying income tax in the year of the client's death, instead of deferring withdrawals until 5 years after her death, which is what they had expected could occur.

So remember, discounting with annuities will probably not work, and should not be considered as a viable planning option.

**7. Lifetime Gifts of Annuities Can Trigger Premature Ordinary Income And Medicare Tax.** The gift of an annuity to anyone other than to a spouse will generally cause the transferor to be subject to income tax as if all of the deferred income in the annuity had been withdrawn. This is treated as ordinary income to the donor at the time of the transfer. In other words, Internal Revenue Code Section 72(e)(4)(C) provides that if a deferred annuity contract is transferred without adequate consideration, then a deemed distribution of the built-in gain in the contract gain occurs to the donor.

An exception applies when the donee is a spouse or the transfer is made incidental to a divorce. The donee or divorced recipient spouse will have the same investment in the contract as the donor spouse previously had.

The bottom line is that lifetime gifts of annuities will trigger income tax to the owner of the annuity contract. There are very limited exceptions to this rule.

**8. Commissions Can Influence Judgment.** Most consumers are not apprised of high commissions on annuity purchases which can be 7% or more, annual 12b-1 fees (an annual marketing or distribution fee considered as an operational expense) that may be 0.3% per year or more, and other rewards that can influence a salesperson to favor these products over mutual funds or other investments that may pay smaller commissions, cost the investor less in fees, and provide less exposure for surrender charges.

The fact is that advisors can be influenced by how they get paid. If an advisor has the choice of selling a mutual fund that pays a 3% commission and an annuity contract that pays a 7% commission, it seems that the advisor is incentivized to recommend the annuity product if all other things are equal. What about if all other things are not equal? This is the problem that many financial advisors believe is rampant in the annuity industry.

Also, it is very difficult to get an objective second opinion because many financial advisors honestly just do not fully understand these contracts because of how complicated they usually are.

Author Eve Kaplan explains that “advisors and agents emit howls of protest when criticized for pushing variable annuities but there are few things more lucrative as selling a variable annuity. . . . Advertisements that prey on retirement fears (a gorilla on a plane, elevator, or elsewhere - the perils of ignoring your retirement) are very effective in tapping fears about outliving assets in retirement.”

9. **Borrowing or Pledging Can Trigger Income Tax.** Unlike life insurance products, monies borrowed from annuity contracts (or by pledging of the contract) are taxable to the extent that the contract has taxable income built up, and the transfer by gift of a contract (other than to a spouse) will trigger income tax as if the contract were sold to the transferee. Life insurance death benefits and loan elimination on death happen tax-free, which is contrary to what occurs with annuities when the monies therein are eventually paid out.

You cannot borrow or pledge on an annuity without triggering the income that is within the annuity contract. Life insurance does allow tax-free borrowing, but can be an expensive investment vehicle that should be carefully explained and understood by anyone who owns or purchases a life insurance policy for investment purposes.

10. **Many Trusts Cannot Qualify To Hold Annuity Contracts, Causing Ordinary Income Treatment When Not Expected.** Trusts are frequently constructed with the goal of preserving and protecting assets, along with avoiding federal estate tax at the level of a surviving spouse or for one or more generations.

Annuities held by or payable to a revocable trust during the lifetime of a grantor will be treated for tax purposes as if they are owned by the grantor, although state law creditor protection might be compromised if a statute protects individual owners and beneficiaries, but not trusts.

Irrevocable trusts may be disregarded for income tax purposes, in which event annuity contracts owned by such trusts will be considered as owned by the grantor or a beneficiary depending upon which “grantor trust” rules apply.

Irrevocable trusts may also be “complex trusts” which are taxed as separate taxable entities in their own income tax brackets, the highest bracket of which is presently 39.6% on income not distributed that exceeds \$12,150 a year. The 3.8% Medicare tax also applies above the \$12,150 threshold for undistributed trust income.

However, if an irrevocable trust requires that all income be distributed annually to the income beneficiaries, then the trust may be a “simple trust” for federal tax purposes.

Under Internal Revenue Code Section 72(u), annuity contracts must be held by natural persons or by an agent for a natural person. Private Letter Rulings 9204014 and 9204010 concluded that annuity contracts owned by trusts for one specified individual beneficiary would be treated as

being owned by a “natural person” for tax deferral purposes. In these Rulings, the IRS ruled that where a non-grantor trust that has only one individual beneficiary holds an annuity contract, the contract can be treated as owned by a natural person.

A number of Private Letter Rulings<sup>4</sup> have come to the same conclusion, but none of these Rulings (except possibly one<sup>5</sup>) have stated that an irrevocable trust that benefits multiple beneficiaries can be the owner of a tax-deferred annuity where the trustee has the ability to “spray” income and/or principal among multiple beneficiaries.<sup>6</sup>

In addition, the IRS has not yet ruled on whether an unborn person is a “natural person” for the purposes of Section 72(u), which would be an issue if a trust holding an annuity contract does not pay out to individual beneficiaries, but instead is held for the benefit of future generations indefinitely (or at least until the perpetuities period runs). However, it is *suggested* in Private Letter Rulings 199933033 and 200449016 that unborn heirs are considered “natural persons.”

Most of the Private Letter Rulings have been based upon factual scenarios where the trust documents specifically require that any one or more annuity contracts will be used solely for one named beneficiary, and in many of the Rulings the contract itself is to be transferred to the one individual beneficiary that the contract has been purchased to benefit. For example, Private Letter Ruling 201124008 allowed a multiple beneficiary trust to hold multiple annuity contracts, but the trust required that each separate contract be designated for a separate individual beneficiary, and that each contract would eventually be distributed to the designated beneficiary. It is not known why each of the Private Letter Rulings was couched in these terms.

The authors believe it is safe for a revocable trust to hold an annuity contract, and an irrevocable trust that is disregarded for income tax purposes is probably alright as well, but the carrier may not be able to get comfortable with it. A transfer of annuity contract to an irrevocable trust that is treated as a complex trust (which is what happens when the consumer dies with a revocable trust) may trigger recognition of the income in the contract.

There are Private Letter Rulings regarding “complex trusts” which basically say that if the irrevocable trust holds the annuity contract for the sole benefit of one person and one person only, and any distributions of that annuity contract from the trust go only to that one person, then you probably do not have a trigger. However, if you have a spray trust which essentially says, “hold this for my lovely child and his children,” then there is one Private Letter Ruling which might support your situation.

This is a treacherous area. It is hard to do generation skipping tax planning when the annuity is only payable directly to the children. In this kind of situation, it is also difficult to protect the children from creditors, divorce, and their own mischief.

11. **Not Necessary to Hold an Annuity Under an IRA.** Oftentimes annuities are sold to be held under IRAs, where tax deferral and creditor protection is already in place, and costs imposed in these situations will normally significantly reduce performance.

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4 PLR 9204014, 9204010, 9752035, 199905015, 201124008

5 PLR 199933033. This Private Letter Ruling is further discussed in Chapter 7

6 Spraying means distributing income and principal among various beneficiaries as determined appropriate by the Trustee, in the trustee’s discretion.



If you have an IRA, why does it need to be invested in an annuity? If the purpose of an IRA is to defer income tax, and the annuity defers income tax anyway, then why have an annuity and an IRA? It should be noted that some advisors are not licensed to sell anything but life insurance and annuity products, so they cannot sell consumers mutual funds or other investments for their IRA. This may be the only reason why they would exclusively push annuities. Some consumers want the financial guarantees that apply to their IRAs, but holding an annuity under an IRA is redundant and unnecessary because there are no additional tax advantages.

12. **Many Contracts Are Illiquid Because Of Surrender Charges.** Significant surrender charges typically apply in the first 7-8 years of a contract that result in the contract holder only being able to withdraw 10% of the value of the contract each year without incurring significant unforeseen charges. A typical contract costing \$1,000,000 and growing in value based upon the performance of an index, may have surrender charges as described below:

<i>Allianz 222 Indexed Annuity</i>				
<b>Illustrated Surrender Charges</b>				
Year	Surrender Charge	Account Value	Surrender Charge	Cash Value
1	10%	\$ 1,000,000.00	(\$100,000.00)	\$ 900,000.00
2	10%	\$ 1,104,662.00	(\$110,466.20)	\$ 994,195.80
3	10%	\$ 1,211,821.00	(\$121,182.10)	\$ 1,090,638.90
4	8.75%	\$ 1,305,119.00	(\$114,197.91)	\$ 1,190,921.09
5	7.50%	\$ 1,419,701.00	(\$106,477.58)	\$ 1,313,223.43
6	6.25%	\$ 1,451,345.00	(\$90,709.06)	\$ 1,360,635.94
7	5.00%	\$ 1,458,986.00	(\$72,949.30)	\$ 1,386,036.70
8	3.75%	\$ 1,752,927.00	(\$65,734.76)	\$ 1,687,192.24
9	2.50%	\$ 1,968,205.00	(\$49,205.13)	\$ 1,918,999.88
10	1.25%	\$ 2,216,317.00	(\$27,703.96)	\$ 2,188,613.04
11	0.00%	\$ 2,343,597.00	\$0	\$ 2,343,597.00

13. **Annuity Contracts are Often Sold as Legal Solutions to the “Probate Problem.”** Many salespeople tout the feature of probate avoidance by means of using beneficiary designations as a key reason to purchase an annuity contract. What they do not mention is that pay on death accounts can hold less expensive financial products, or stocks, bonds, and cash, and have the same result. Further, individuals who do not get appropriate legal advice will typically have benefits payable to individuals, without addressing what would happen if those individuals did not survive, and may prefer to use testamentary or living trusts to provide creditor, investment management, divorce, and other recognized protections once they understand these concepts.

14. **Difficult to Get an Objective Second Opinion.** It is very hard to get an objective second opinion from those who feel strongly that annuities are worthwhile investments. Those who would oppose them cannot be nearly as well compensated as those who support them. Non-commissioned annuities sellers and those who structure low cost private annuity contracts for larger situations may be good sources of advice in this area.

The people who sell annuities are highly motivated to promote their products. For the rest of the population, these products are extremely complicated. There are, however, some hedge funds who recommend private annuity contracts to their clients and some advisors who understand private annuity contracts. In other words, instead of going to an annuity insurance carrier you can go to a

private company, which will do a private annuity contract that will qualify for all the federal income tax benefits, and will be less expensive than any of the commercial annuities. However, those advisors are few and far between.

We have reviewed a number of books about annuities, and almost all of them are written by individuals who make their living deriving commissions from the sale of these products.

15. **Carriers May Change Terms Without Advance Notice.** The vast majority of annuity contracts permit the carriers to change expenses, sharing ratios, and other terms, which is perhaps best described by the following July 26, 2013 Nerd's Eye View blog post by Michael Kitces, who is with Pinnacle Advisory Group.

**AXA and Hartford Prospectus Changes a Troubling New Trend for Existing Variable Annuities**  
**By: Michael Kitces, Posted Wednesday, June 26, 2013**

Over the past 15 years, the variable annuity industry has experienced a tremendous amount of change - from the explosive rise of variable annuities with guaranteed living benefit riders for retirement income leading up to the fall of 2008, to the dramatic pullback of many insurers away such offerings in the aftermath of the financial crisis. While ultimately many annuity owners who purchased contracts prior to 2008 have been happy with their contracts and the guarantees, the same has not been true of the annuity companies who offer them, as a rising number of insurers have been offering buybacks to annuity owners that offer contract value increases or outright cash in exchange for releasing the company from their guarantees in order to reduce exposure.

In a disturbing new trend, though, several annuity companies have begun to make changes to the investment offerings, ostensibly to simply change the lineup of funds being offered, but done in a way that increasingly appears to change the rules of the game for existing annuity holders after the fact. The first shot across the bow came earlier this spring from AXA, who in the process of rotating investment offerings in a 'routine' prospectus change indirectly defaulted a large number of annuity holders into more conservative investments than they may have originally selected (and often into their own affiliate-managed funds to boot). In a more concerning shift, now Hartford has decided to change its investment offerings as well, and actually require policyowners to voluntarily adopt the new investment offerings or lose their annuity guarantees! In other words, a number of contract owners with what were purported to be lifetime guarantees are now renewed to complete a "renewal" process by October 4th or permanently lose their lifetime income protection!

While such a move is certainly not popular, the reality is that because several companies making recent changes - including Hartford - are not in the business of offering variable annuities anymore, the potential fallout to the companies in damage to their brands is arguably limited. Nonetheless, this emerging trend to alter annuity contracts after the fact by changing the prospectus and attaching requirements to continue the guarantees puts new pressure on advisors to monitor on behalf of clients, and arguably even advisors who didn't originally sell the annuity could still be liable if they're engaged for ongoing monitoring of the client's comprehensive financial plan and miss a crucial change to the guarantee! As a result, advisors will need to be increasingly diligent in reviewing client annuity contracts, or look to outsource to due diligence services that can help to support the process.

**Variable Annuities Over The Past 15 Years**

Although the first Guaranteed Minimum Income Benefit (GMIB) riders on variable annuities came out in the late 1990s, the offers really gained popularity in the early 2000s, a combination of early baby boomers getting within striking distance of retirement, and the aftermath of the 2000-2002 tech

crash that reminded investors that markets can go down as well as up. A few years after the crash, the first Guaranteed Minimum Withdrawal Benefit (GMWB) riders were released - generally viewed as an improvement or at least a simpler and more palatable alternative of their complex GMIB cousins - and the marketplace took off even further. By the financial crisis in 2008, nearly 90% of all variable annuities being issued had some form of Guaranteed Lifetime Benefit (GLB).

However, the reality that became apparent when the financial crisis hit was that some annuity companies were engaging in hedging strategies to manage their exposure to their guarantees, while others were not. Even companies that were seeking to protect themselves had not anticipated the extent and magnitude of the crisis that hit; with more than \$500 billion of new variable annuity sales in just the 2003-2008 time frame, just a small amount of hedging leakage still had significant financial ramifications. Furthermore, in the aftermath of the crisis, it has become clear that many companies misjudged how many consumers would keep their contracts. As a result of the sometimes incomplete hedging and unexpectedly low lapse rates, some companies were forced to make tremendous allocations to reserves to back their guarantees after the market fell, resulting in a significant multi-year hit to profits. Variable annuity leader The Hartford was ultimately forced to seek liquidity from the Federal government to help manage its exposure, and overall the market capitalization of the 10 largest insurers fell by over 50% through the financial crisis.

In the wake of the 2008-2009 market crash, variable annuity companies have significantly shifted in their offerings of guarantees to new investors. Many companies have deliberately adjusted the offerings on their new contracts, with higher costs and lower guarantees, in an effort to stem the amount of flows coming in by making them less appealing. In some cases, the goal was to expand the profit margin - and therefore, the padding against uncertainty - of the products, while in other cases the rising costs and restrictions are simply reflective of the increased cost to manage and hedge risk in the post-2008 environment. In addition, most offerings also restrict the available investment options, forcing asset allocation portfolios that limit the risk exposure of the insurance company by limiting the exposure to equities and other risky assets in the annuity. And many annuity companies - including the prior market leader Hartford itself - have simply decided to stop offering variable annuities with living benefit riders altogether.

### **Handling Pre-Crisis Annuities in a Post-Crisis World**

While the shifting variable annuity landscape has forced new buyers to assess their potential contracts and guarantees more carefully, the focal point for many companies has been not on how to handle the new contracts they offer, but what to do about all the existing contracts issued prior to 2008, many of which are still either "in the money" (where the contract is underwater relative to the guarantees) or at the least are offering more generous benefits at lower costs with fewer restrictions than what companies are willing to issue today.

For the past several years, annuity companies such as AXA, Hartford, Transamerica, and more, have sought to reduce their exposure to pre-2008 contracts by offering "buybacks" where annuity holders are credited with a lump sum that increases their current cash value, in exchange for agreeing to walk away from the prior guarantee. Consumers whose contracts weren't very far in the money, or whose needs may have changed since the contract was originally issued, could decide for themselves whether it was now more desirable to simply walk away. Unfortunately, though - at least from the annuity companies' perspective - buybacks have not reduced the exposure of the companies as much as was hoped for (although in the 4th quarter of 2012 variable annuities had a net outflow driven by buybacks), and contract persistency remains high; not surprisingly, many of the contracts with previously generous guarantees, that are now in the money, were contracts that the annuity owners have decided they want to hold on to, resulting in unexpectedly low lapse rates.

As a result, variable annuity companies are now exercising their rights in a more aggressive manner to manage their risk exposures. For instance, many contracts - especially those issued in the last few years leading up to the financial crisis - had options to increase the cost of the annuity riders "just in case" and companies are now exercising those options to increase the annuity costs. Similarly, some contracts had asset allocation restrictions that were not previously enforced against policyowners, but are now being applied, requiring the annuity owners to shift their investments to more conservative options, whether they wanted to or not.

Still not reduced risk exposure enough, though, some companies have taken to even more concerning steps in recent months. This spring, AXA Equitable started a new trend in announcing that the company had filed for updates to its prospectus that would change its investment line-up and impact about 500,000 annuity policies; while nominally the purpose of the change was to eliminate some old fund options and offer new "better" ones, in many cases the replacement funds were more conservative than the original ones, indirectly defaulting (or sometimes forcing) annuity holders to become more conservative, even if they didn't want to. In addition, some of the default replacement funds also offered a new "volatility management" feature that would essentially allow the company to change the allocations of its investors at the fund level since many older contracts didn't otherwise have provisions to allow the company to change the allocations at the contract level. Furthermore, it was notable that many of the prior third-party investment offerings were outright swapped out for AXA's own funds or those of its affiliate companies. In other words, since AXA's risk exposure couldn't be managed by forcing annuity owners to make allocation changes, it forced the result indirectly by altering its prospectus to limit the investment offerings.

And unfortunately, it turns out that AXA's decision to change its prospectus as a way to alter the contract offerings after the fact may have been the tip of the iceberg. In recent weeks, Hartford - which has stated on the record that "we are determined to reduce the size and volatility of our legacy annuity liabilities" announced its own prospectus-driven changes, which are even more severe than AXA's. Not only will the company be applying investment restrictions to its allocations, force annuitization for older policyowners who reach the required starting date, and eliminate many favorable features - which were permissible under the original contract as issued - but the Hartford also announced that it will change its investment options as well. And in perhaps the most shocking step, Hartford announced that policyowners who don't voluntarily opt in to the new investment choices by October 4th, and move at least 40% of their holdings into bond funds, will lose their existing variable annuity guarantees; *in other words, through prospectus changes, Hartford just created a requirement to renew what was previously supposed to be a guaranteed lifetime income rider!* An estimated 60,000 clients will be affected by at least some of the proposed changes.

### **Annuity Outlook and Concerns From Here**

The shifting environment for annuities has placed *a new series of burdens and risks on the shoulders of financial planners, including those who have sold annuities in the past and those who have not.* The issue - especially in the case of the latest change by Hartford - is that the failure of a policyowner to act can result in the permanent loss of their lifetime guarantee, and if such a lapse occurs, there's a risk that the current advisor may be blamed for the failure. In fact, several broker-dealer executives have been pushing back against the Hartford, concerned about the burden placed on the financial advisor to reach every policyowner by October 4th to avoid the lapse of their guarantees, or risk a lawsuit from the policyowner in the future if the rider lapses accidentally.

However, arguably even a current advisor who didn't sell the annuity could face liability for failing to advise the client to take the steps necessary to ensure the continuation of the guarantee, especially if the advisor is otherwise being paid for ongoing investment management and monitoring. In a world where these kinds of annuity changes may occur with increasing frequency - given Hartford's decision to implement prospectus changes after AXA, it may mark the beginning of a more aggressive trend by companies to reduce their annuity exposures through prospectus changes and scenarios where clients are defaulted out of their guarantees unless they act - even fee-only advisors may have to be more cautious than ever to do effective due diligence in reviewing existing variable annuities and crafting appropriate strategies. Alternatively, this rising liability exposure of advisors to oversee annuities - even potentially those they didn't sell originally - may increase the appeal of services like Annuity Review, which offers to become a Broker of Record of existing annuities to help the non-sales advisor monitor the contracts on an ongoing basis. Especially since the earliest announcements of the Hartford changes were made not to the policyowners, but the brokers of record on the contracts (in fact, the first notice of this issue came to my attention through Annuity Review expert Mark Cortazzo).

Beyond the risk that more insurance carriers will take aggressive stances in trying to change existing variable annuities through prospectus changes, the current environment provides an important reminder that due diligence on annuities and their guarantees are crucial, to ensure that the company is not overpromising on benefits that it cannot deliver. In today's environment, annuity companies are increasingly leaving themselves options in the contract provisions to change the terms, to avoid the risk to the company of being caught on the hook - but such changes also mean there is arguably an increased risk that companies may alter the rules of the game for today's annuity buyers after they purchase, potentially resulting in a scenario where the guarantees or returns don't turn out as favorable as originally anticipated (with little recourse for the investor). And **in many cases, the best option for the client is specifically to *not* walk away** - in fact, the whole point of this process from the annuity company's perspective is to encourage consumers to lapse what are otherwise very favorable guarantees on their behalf! To say the least, deciding what to do requires a thorough analysis of the available strategies for existing GMIB and GLWB riders (which often are to keep the contract and begin guaranteed withdrawals, *not* surrender them!).

The bottom line, though, is simply this - if you're dealing with clients and annuities at all, whether offering them new contracts or simply doing work with clients who have existing annuities, the pressure is on right now for an increasingly proactive monitoring process to ensure that clients don't accidentally lapse their guarantees, especially if more and more companies begin to alter their prospectuses in the coming years as they try to reduce their exposure to guarantees. On the plus side, it appears that regulators are finally starting to take notice of these prospectus changes that seem to be changing the rules of the game after the fact, in ways not originally anticipated. Nonetheless, the changes are happening, and while they are unpopular, in many cases - including with Hartford - **the companies are no longer in the business of offering annuities anyway, which means they may be less concerned about making such unpopular decisions.** In the meantime, though, expect to see a continued rise of "next generation" annuities focused on delivering benefits through alternative means - such as providing tax deferral for higher return alternative investments as an asset location tool - where annuity companies can generate a modest profit for insurance companies but without the risk exposures of significant living and death benefit guarantees!

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Michael E. Kitces, MSFS, MTAX, CFP, CLU, ChFC, RHU, REBC, CASL  
Pinnacle Advisory Group, Inc.  
6345 Woodside Court, Suite 100  
Columbia, Maryland 21046  
Tel. (410) 995-6630 michael@kitces.com Fax. (410) 505-0960

**An Example of Customer Confusion and Marketplace Distortion – New York Life Plan Endorsed by AARP**

AARP received \$158,180,231 in endorsement income in 2012 according to its Internal Revenue Code Form 990.

The New York Life plan endorsed by AARP is a good example of a fixed annuity. The AARP website strongly encourages the purchase of these annuities from New York Life, and does not disclose the financial arrangement between them or that other carriers may offer similar products at a lower cost.

By way of example, if an individual age 60 puts \$1 million in with New York Life, he or she can receive payments of \$53,888 a year for the rest of their life. This may be an appropriate investment for someone with a long life expectancy, but the authors rarely see life annuities purchased when clients are using paid professional advisors.

The website refers to a “Rate of Return,” which could lead an unsophisticated 60 year old to think that the annuity offers a 5.388% rate of return on investment. In reality, however, if the person lives to their life expectancy then their rate of return is 0%, because to the extent that they have not received payments totaling \$1 million (the original investment) before they die, then the excess of the amount invested over the amount of payments made will be paid by the carrier. This is called a refund feature, but the name is deceiving because no interest is added, so the refund equals 0%. A typical investor would be expecting to receive 5.388% on the money, and then a return of all principal on death.

Our calculations show that even if the person lives to age 105, the rate of return will be under 4.5%.

Vanguard’s insurance carrier (Vanguard Annuity Advisor Services) has a higher rating than New York Life, and would pay the investor \$54,026 annually for life. However, Vanguard does not offer the payment acceleration one-time cash withdrawal features that the New York Life AARP product offers. Most typical investors, however, will not make significant use of these features anyway.

Some representative AARP print-outs and comparison between AARP and Vanguard products appear below.

## Guaranteed Income for as Long as You Live

The AARP Lifetime Income Program offers annuity options to help protect against the risk of outliving your savings. Exclusively for AARP members, from New York Life Insurance and Annuity Corporation, these fixed immediate annuities can help you:

- Turn part of your savings into guaranteed income you can't outlive
- Lock in a monthly income stream for life
- Receive fixed payments regardless of market conditions

### Lifetime Income with Cash Refund

Fixed immediate annuity for AARP members  
ages 50 to 89

Receive guaranteed monthly income payments  
for life

"Cash Refund" feature: If you die before your  
total payments equal your annuity purchase  
price, your beneficiary will be paid the difference

Purchase using funds from savings and CD's  
or a 401(k) or IRA

Payments begin immediately and never change,  
regardless of market conditions

Single or Joint Life Plans Available

[» More Information](#)

### Lifetime Income with 10 Year Guarantee

Fixed immediate annuity for AARP members  
ages 50 to 85

Receive guaranteed monthly income payments  
for life

"10 Year Guarantee" feature: If you die before 10  
years have passed, your beneficiary will receive  
the remaining monthly payments during the  
10-year guarantee period\*

Purchase using funds from savings and CD's  
or a 401(k) or IRA

Payments begin immediately and never change,  
regardless of market conditions

Single Life Plan available

[» More Information](#)

Relax and enjoy retirement  
more by turning a portion of  
your savings into a guaranteed  
monthly income stream.  
Explore how this annuity  
program works, who it's for,  
and how it may help.

[» How It Works](#)

[Monthly Income Example](#) Take a Look at a Guaranteed Monthly Income Example

\* Total payments received may be more or less than what you paid into the annuity, depending on how long you live.

### Strength of New York Life Insurance and Annuity Corporation, Program Endorsed by AARP

The AARP Lifetime Income Program is  
endorsed by AARP, a nonprofit  
membership organization that helps people  
50 and over improve the quality of their  
lives.

### Not an AARP Member Yet?

The AARP Lifetime Income Program is  
exclusively for AARP members. In most  
states, if you're not a member, you can still  
request your free Information Kit by  
clicking the link below.

[Get a Free Information Kit »](#)

### Quick Links

[A Guide to the AARP Lifetime Income  
Program »](#)

[How Can This Annuity Benefit Me? »](#)

[Lifetime Income Annuity Articles »](#)

[What Makes Us Different >](#)

### Enroll for Lifetime Income in Four Easy Steps

#### Choose an Annuity

Get a free Information Kit with personalized Lifetime Income quote by mail.

#### Complete an Enrollment Form

Review your Information Kit and mail your Enrollment Form.

#### Fund Your Annuity

Make just one payment, by check or funds transfer.

#### Receive Your Income

Start getting your monthly income payments.

Ready to see how a Lifetime Income group annuity can fit into your retirement strategy?

[Get Started](#)

 [Talk to an Annuity Specialist:](#)

Call **New York Life at 1-800-590-1455**

8 a.m. to 6 p.m. (Eastern Time) Monday through Friday, or 9 a.m. to 5 p.m. (Eastern Time) Saturday

### Get Started Today!

Request your free information kit and personalized quote.

--Select a Product--

[Go >](#)

#### Quick Links

[Get A Quote >](#)  
[FAQs >](#)  
[What Makes Us Different >](#)

#### Learn More About Annuities

[How Can This Annuity Benefit Me? >](#)  
[Things to Consider When You're Ready to Make an Annuity Purchase >](#)

[Home](#) [Learning Center](#) [Customer Service](#) [Claims](#) [Contact](#) [Site Map](#)

New York Life Insurance and Annuity Corporation pays royalty fees to AARP for the use of its intellectual property. These fees are used for the general purposes of AARP. AARP and its affiliates are not insurers. AARP has established the AARP Annuity Trust to hold group annuity contracts for the benefit of AARP members.

The AARP Lifetime Income Program is underwritten by New York Life Insurance and Annuity Corporation (NYLIAC), a Delaware Corporation (NAIC #91596), Newark, DE 19713. AARP membership is required for Program eligibility. Guarantees are based on the claims-paying ability of NYLIAC. Specific products, features, and/or gifts not available in all states or countries. NYLIAC is licensed in all 50 states. (Group policy form IA-01, IA-02, and IA-04). New York Life Insurance and Annuity Corporation is a wholly owned subsidiary of New York Life Insurance Company.

Complete terms and conditions are set forth in the group policy issued by New York Life Insurance and Annuity Corporation to the Trustee of the AARP Annuity Trust.

The licensed agent is Michael Horan (Arkansas #280279, California #0859435).

Residents of Florida: Michael Horan is a licensed Florida agent for service to Florida residents.

Residents of Kentucky: A free Buyer's Guide is available upon request.

A101-9220914-LIPMAN

[Privacy Policy](#)

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<http://www.nylaarp.com/Annuities>

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## Monthly Income Examples

The payouts shown below are examples only, based on the state, age, and gender you entered. Actual monthly income will be based on other factors as well. To get your personalized Lifetime Income quote, request a [free Information Kit](#) by mail.

Example Based On:

State: FL

Age: 60

Gender: Male

[Edit Information >](#)

### Lifetime Income with Cash Refund Examples\*

\$213.00 / month  
purchase amount of \$50,000

\$439.00 / month  
purchase amount of \$100,000

\$1,109.00 / month  
purchase amount of \$250,000

Get annuity details and a personalized  
Lifetime Income quote by mail.

Fixed immediate annuity for AARP members ages 50 to 89

Receive guaranteed monthly income payments for life

\*Cash Refund\* feature: If you die before your total payments equal your annuity purchase price, your beneficiary will be paid the difference

Purchase using funds from savings and CD's or a 401(k) or IRA\*

Payments begin immediately and never change, regardless of market conditions

Single or Joint Life Plans available

[More Information >](#)

### Lifetime Income with 10 Year Guarantee Examples\*\*

\$225.00 / month  
purchase amount of \$50,000

\$462.00 / month  
purchase amount of \$100,000

\$1,165.00 / month  
purchase amount of \$250,000

Get annuity details and a personalized  
Lifetime Income quote by mail.

Fixed immediate annuity for AARP members ages 50-85

Receive guaranteed monthly income payments for life

\*\*10 Year Guarantee\*\* feature: If you die before 10 years have passed, your beneficiary will receive the remaining monthly payments during the 10-year guaranteed period. The total payments received may be more or less than what you paid into the annuity, depending on how long you live.

Purchase using funds from savings and CD's or a 401(k) or IRA\*\*

Payments begin immediately and never change, regardless of market conditions

Single Life Plan available

[More Information >](#)

\*The annuity income shown above is before any applicable federal and state taxes and includes interest plus return of principal. Effective on 9/22/2014 and may vary by state.

\*\*The annuity income shown above is before any applicable federal and state taxes and includes both interest and principal. Effective on 9/22/2014 and may vary by state.

## Annual Payout by Age

### Putting \$1,000,000 in AARP Lifetime Income With Cash Refund

(If the person dies before receiving a full \$1,000,000, in payments the difference is refunded back - essentially making this an interest-free loan to New York Life.)

Age of Individual	Male's Annual Income	Female's Annual Income
60	\$53,880.00	\$51,360.00
65	\$56,190.00	\$56,040.00
70	\$65,880.00	\$62,160.00
75	\$74,520.00	\$69,840.00
80	\$84,960.00	\$79,560.00

## Comparison of Fixed Annuity Providers

We have the AARP and Vanguard rates below with the refund feature, and you can see that Vanguard pays significantly more. The non-refund feature also demonstrates that the Vanguard annuity with no refund pays a lot more, because if a carrier does not have to have the option to refund then it is able to pay more.

### \$1,000,000 Investment for Immediate Annuities: Annual Income from Each Plan

Age/Sex of Individual	AARP Immediate Annuity w/ Refund	Vanguard Immediate Annuity w/ Refund	Difference	Vanguard Annuity w/ No Refund
55 Year Old Male	\$51,676.00	\$54,026.00	\$2,350.00	\$57,266.40
75 Year Old Male	\$74,520.00	\$76,217.16	\$1,697.16	\$92,269.08

$$\$2,350 \times 25 = \$58,750.00$$

$$\$1,697 \times 10 = \$16,970.00$$

“With Refund” means that upon death any excess of the total purchase price over payments received will be refunded, without interest.

This may work well with an investor such as a widow age 75, with \$100,000, who is afraid to pay principal. Her kids are there to help her, she gives AARP her \$100,000 in exchange for \$7,452 a year for life, and she may feel more comfortable.

**Comparison of Fixed Annuities After Tax From Each Plan**

<b>Age/Sex of Individual</b>	<b>AARP Immediate Annuity</b>	<b>Vanguard Immediate Annuity</b>	<b>Difference</b>	<b>Vanguard Annuity w/ No Refund</b>
55 Year Old Male	\$44,423.00	\$48,308.00	\$3,885.00	\$50,576.00
75 Year Old Male	\$74,520.00	\$76,217.00	\$1,697.00	\$86,944.00

$$\$3,885 \times 25 = \$97,125.00$$

$$\$1,697 \times 10 = \$16,970.00$$

## CHAPTER 4

### ANNUITY CONTRACT PLANNING STRATEGIES

There are many strategies that an advisor can employ in helping clients to get the best results in situations where they have or are considering holding their investments under an annuity contract. Because of the complexities and product specific differences that will be found in working with annuity planning, the authors strongly recommend conferring with an experienced and licensed agency and the issuing carrier itself. Most carriers have very knowledgeable personnel who can provide significant information and advice above and beyond what the typical agency or sales person is able to help with.

#### *1. Reducing Expenses of the Investment*

Many annuities have significant annual expenses, and convert capital gains to ordinary income, although deferred.

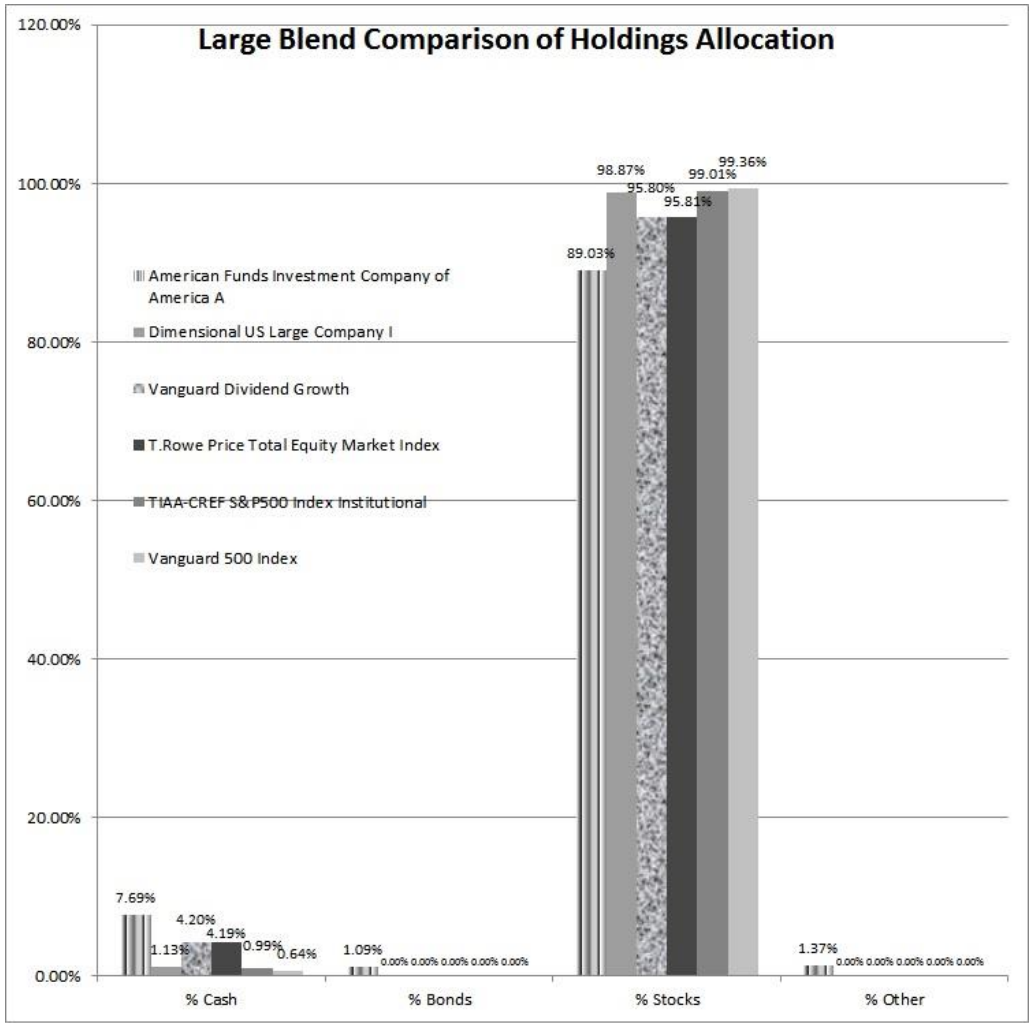
- A. Use index funds (as opposed to index annuities) and less actively traded mutual funds outside of annuities to reduce tax costs. More active mutual funds can be held under IRA or pension accounts.
- B. Use tax free municipal bonds. Higher yielding bonds might work better in an IRA or pension.
- C. No load/low-cost less frills annuities can be purchased or exchanged into.
- D. While bonds are yielding much lower interest than in the past, perhaps keep bond funds outside of annuities and keep higher income investments like mutual funds in annuities.
- E. Consider using 529 Plans where anyone in the family can use the proceeds for college, graduate school, and associated permitted living expenses.

Investors can set up a plan for a child's or grandchild's education, and they can later withdraw the funds and pay for the child's or grandchild's education without paying any tax. The costs are typically lower than with a variable annuity product, and 529 Plan income will never be subject to income tax if used for permitted educational expenses for the intended beneficiary or any other subsequently designated beneficiary. Also, while non-educational 529 Plan distributions are subject to income tax at 10% above the recipient's normal tax bracket, such distributions are prorated to take into account the cost basis of the assets held under the Plan so that if 30% of a 529 Plan value consists of appreciation within the contract, then only 30% of a withdrawal will be subject to income tax at that time, unlike variable annuity income, which normally comes out entirely with each payment until all income has been withdrawn.

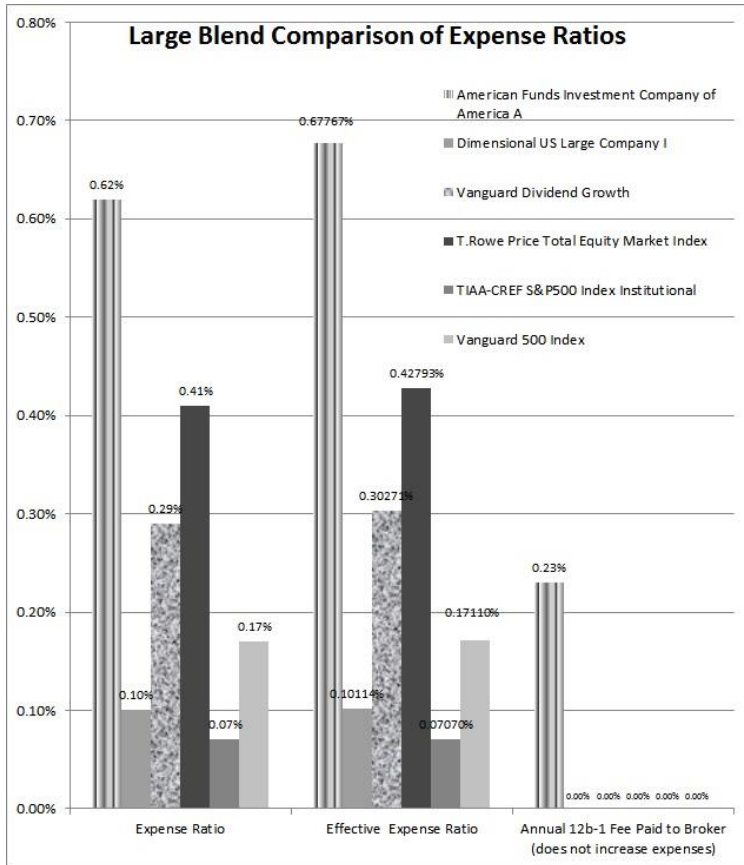
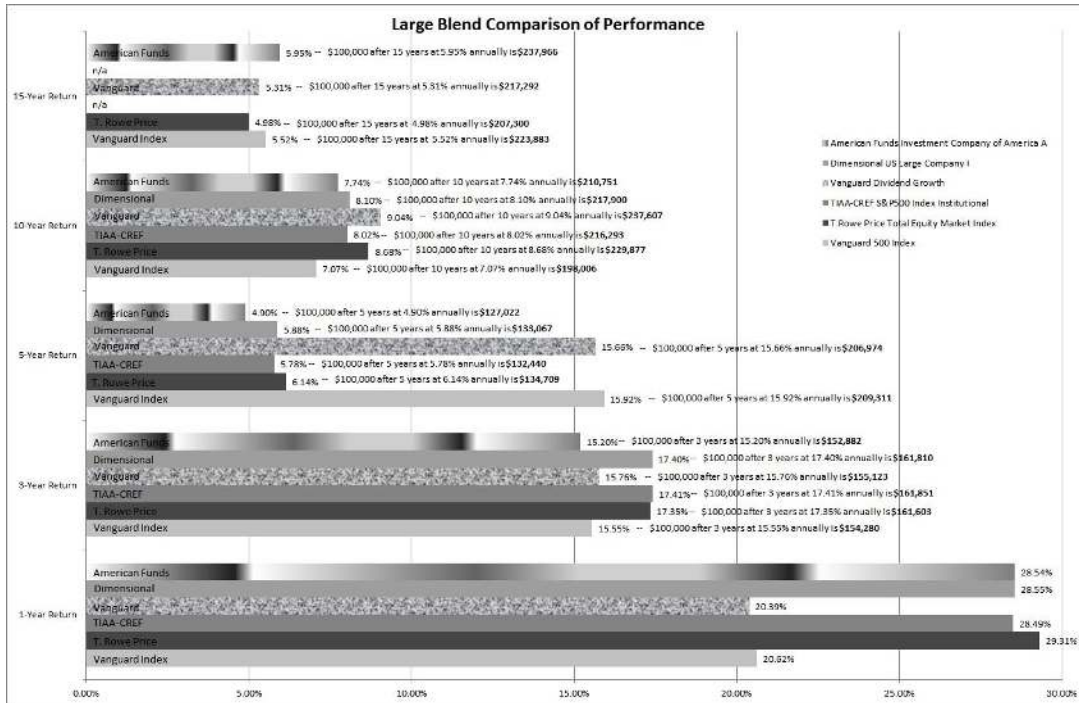
- F. Consider an irrevocable complex trust if income will not exceed \$12,150 per year (the beginning of the highest tax bracket applicable to complex trusts).
- G. Switch off expensive riders that may not be useful, such as "guaranteed payment/income" riders that are commonly misunderstood and many advisors believe to be overpriced. However, many carriers do not allow owners to drop riders once elected, so an exchange to a lower cost product might be required.

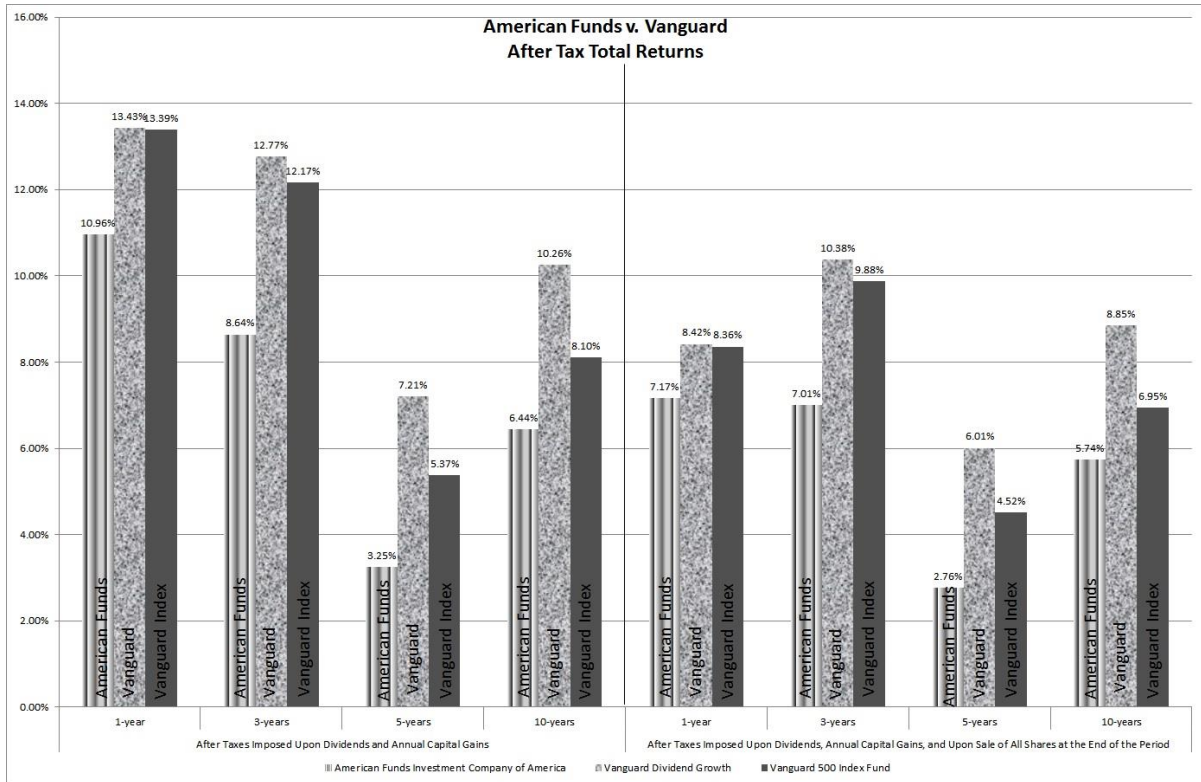
H. Withdraw all available basis from existing life insurance policies that are no longer needed and exchange the remaining policies for annuities to reduce costs otherwise incurred for mortality expenses.

The following chart shows the investment allocation of various mutual funds accounts, which can be held outside of a mutual fund wrapper:



The first chart below shows some pretty competitive very good mutual funds. Many of these are very competitive if you look at their pre-tax rate of return:





## 2. *Avoiding Surrender Charges*

A typical surrender charge schedule would be 8% of cash value if the contract is surrendered in year 1, 7% in year 2, 6% in year 3, 5% in year 4, 4% in year 5, 3% in year 6, 2% in year 7, and 1% in year 8.

Here are some ways to avoid surrender charges:

- A. Buy no-load policies that do not have surrender charges.
- B. Compare surrender charges before purchasing annuity contracts.
- C. Avoid surrender charges by withdrawing no more than 10% per year of the policy value under the vast majority of contracts. If you are in a policy with a large surrender charge, you can still withdraw up to 10% a year surrender-free and you can do a tax-free rollover to another less expensive variable annuity.
- D. Consider annuitizing a portion of the contract and 10% per year withdrawals from the remaining variable portion of the policy.
- E. Hold the annuity contract beyond the requisite period during which surrender charges apply.

## 3. *Reduce Taxable Income on Withdrawals*

- A. Exchange a portion of a single policy with significant income into two separate policies tax-free under Section 1035, and make a withdrawal from one of the separate policies more than 180 days after the exchange.

Example: A policy costs \$50,000 with a \$100,000 value, and the first \$50,000 of withdrawals will yield all taxable income. If the client wants to withdraw \$30,000, then separate the policy into a \$70,000 50% income policy and a \$30,000 50% income policy and withdraw the \$30,000 from the \$30,000 policy 181 days after the separation. The client will pay tax on only \$15,000 of income.

- B. Avoid aggregation rules that will apply when separate contracts have been purchased from the same carrier in the same year by buying separate contracts from separate carriers or in separate years, or two contracts in one year from one carrier.
  - C. Have separate investment funds under each separate annuity contract so that the annuities holding negative funds can be withdrawn from first, while other annuities or investments could be rebalanced.
  - D. Convert variable annuity rights into long-term care policies by having the long-term care policy premiums paid by 1035 exchanges – the portion of income passing to the long-term care policy will never be taxed. Make sure the client knows that part of the investment in the contract (tax basis) is going into the long-term care policy. Further, variable annuities that have “double payment guarantees” to pay for long-term care typically pay these from the cash value, so there is no financial benefit unless or until the cash value completely runs out. If the policy runs out of money, small annual payments continue. Clients often mistakenly think that the guarantee is that principal will remain intact and that the guaranteed payments are like income.
  - E. Postpone withdrawals until the individual has high tax deductions, such as long-term care deductions or possibly charitable deductions after retirement.
  - F. Use fixed periodic payments, annuitized, or other multiple payment options to allow the basis in the policy to be allocated among payments. Consider the Lincoln i4LIFE® Advantage alternative.
  - G. Have a family member who is in a higher income tax bracket purchase an annuity contract and make a lower income family member the beneficiary of the contract.
- 4. *Avoid the 10% Excise Tax on Income Paid to Anyone Other Than A Person Who Has Reached Age 59 ½***
- A. Do not borrow on the policy, because this triggers income tax.
  - B. If payable to a complex trust or a simple trust, consider obtaining a Private Letter Ruling to confirm that payments made by the trust to a beneficiary over 59 ½ will avoid the 10% penalty tax, given the lack of authority in this area, as described in Chapter 3 of this book.
  - C. Make use of a statutory exception:
    - i. Withdraw after taxpayer attains 59 ½ years of age;
    - ii. Payments made after the death of the owner or the annuitant;



- iii. Payments attributable to the taxpayer becoming disabled<sup>7</sup>;
  - iv. Payments that are a part of a series of substantially equal periodic payments, made no less than annually, made for the life or life expectancy of the taxpayer;
  - v. Purchase an immediate annuity
- D. Consider the Lincoln i4LIFE<sup>®</sup> Advantage rider with a variable annuity contract, or other annuitized contracts where the annuitization period meets the substantially equal payments exception.

## **5. Consider Charitable Annuities.**

Charitable organizations are able to issue annuity contracts to donors that can be based upon standard life expectancy assumptions. Typically the charity will issue the annuity contract based upon an initial value assumption that is normally somewhere between 50% to 90% of what an equivalent equal payment lifetime annuity would cost. The donor will receive a charitable deduction based upon that difference, and annual or more frequent income payments that are shielded from tax under the allocation of basis rules, as described in Chapter 10.

Charitable annuities can be based upon one life or two lives, so that a married couple supporting a charity can receive payments for the rest of their lives.

Under unrelated business income laws the charity cannot pledge any specific assets and can use the monies donated for investment or charitable expenditure purposes. If the donor/annuitant has a greater than average life expectancy, then the charity may be able to invest the monies received in a commercial annuity that will make the payments for the lifetime of the donor, and there may be money left for the charity, not to mention that the donor will receive an income tax deduction. The commercial annuity purchased by the charity has to be payable solely to the charity and cannot be pledged as collateral to the donor, or the unrelated business taxable income rules described elsewhere in this book will apply.

## **6. Consider Alternative Strategies for Tax Deferral or Avoidance.**

A. Life insurance policies are similar to annuities, but the death benefit can be paid tax-free, making it possible to completely eliminate income tax on investment growth under the policy, which is not possible for an annuity. Life insurance contracts are normally subject to considerable charges imposed by the carriers that can significantly exceed variable annuity internal charges. These will typically include annual mortality costs to compensate the carrier for the risk of having to pay the death benefit in the year that the insured dies. The annual mortality costs will typically increase dramatically as the insured becomes older.

B. Charitable remainder trusts do not enjoy tax deferral on income derived under an annuity contract held by the charitable remainder trust; however, tax deferral of income received from annuity contracts is not necessary because charitable remainder trusts do not pay income taxes, and there may be other reasons to hold an annuity contract under a charitable remainder trust, such as income recognition, minimum payment guarantees, and other contractual benefits. Nevertheless, any

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<sup>7</sup> Most carriers will require a physician's letter before making a payment that might otherwise be subject to the excise tax for tax reporting purposes.

fiduciary should be sure to review costs, the fact that capital gains are essentially converted into ordinary income, and other factors.

An excellent outline on various income tax avoidance techniques that are available to estate planners that has been presented recently by Professor Jerry Hesch can be obtained by emailing:

Professor Hesch at [jhesch@bergersingerman.com](mailto:jhesch@bergersingerman.com) or  
Alan Gassman at [agassman@gassmanpa.com](mailto:agassman@gassmanpa.com).

The authors thank Professor Hesch for everything he has done with respect to development and teaching of income tax avoidance techniques for estate and financial planners.

## CHAPTER 5

### CREDITOR PROTECTION CONSIDERATIONS

Aside from tax and asset selection planning considerations, asset protection and financial guarantee features of annuity contracts can be unique and attractive. Many states, including Florida, Michigan, and Texas, have statutes that exempt annuity contracts from creditor claims, subject to normal exceptions, including fraudulent transfer statutes and federal “super creditors,” such as the IRS and the Federal Trade Commission, that preempt state creditor exemption laws.

Caution must be exercised, because the actual rules that are summarized below may not apply in certain situations, such as if the Internal Revenue Service or other arm of the federal government, which has been granted “super creditor” status, is a creditor, situations where divorce law will override creditor protection law, situations where annuities are not owned and made payable in the exact manner that the statute protects, and situations where annuities are purchased under circumstances where creditor protection may not apply because of fraudulent transfer and similar rules.

While a contract may be protected from the creditors of the owner or owners, the question as to whether a beneficiary’s contracts will be protected from his or her creditors will be a matter of the law of the state where the beneficiary resides.

Many senior citizens also confuse creditor protection with Medicaid eligibility planning, which are two completely separate things. Some annuity arrangements may actually preserve family assets while allowing someone to have the benefits of the Medicaid nursing home program, while other arrangements can cause a person to actually run out of assets completely and still not qualify for Medicaid!

The following is a list of the creditor protection afforded to life insurance proceeds and annuity proceeds for selected states:

<b>State Name</b>	<b>Life Insurance Proceeds</b>	<b>Annuity Proceeds</b>	<b>Applicable Section(s)</b>
California	Unmatured policy wholly exempt from creditors; provided, however, that loan value of only \$9,700 (\$19,400 if debtor is married) is exempt. Death benefits exempt to extent reasonably necessary for support of debtor, and spouse and dependents of debtor.	Unmatured policy wholly exempt from creditors.	Cal. Code Civ. Proc. §704.100
Colorado	Interest in up to \$100,000 of cash surrender value (except for increase attributable to previous 48 months contributions) exempt from creditors of insured except where beneficiary is estate of insured.	None.	Colo. Rev. Stat. §§ 13-54-102(1)(l) and (s)

<b>State Name</b>	<b>Life Insurance Proceeds</b>	<b>Annuity Proceeds</b>	<b>Applicable Section(s)</b>
	Death benefit payable to beneficiary (other than estate of insured) wholly exempt from creditors of insured.		
Florida	Owner and beneficiaries' interests in proceeds are wholly protected from insured's creditors, but not after the death of the insured unless state law where the beneficiary resides provides protection. While alive, the owner/insured's interest is protected if he or she resides in Florida.	Interest in proceeds of policy wholly exempt from creditors of the "Beneficiary". The Beneficiary is the owner during his or her lifetime and then the named Beneficiary upon the death of the owner or annuitant.	Fla. Stat. §§ 222.13 and 222.14
Illinois	Proceeds and cash value payable to insured's spouse, child, parent or other dependent is wholly exempt from insured's creditors.  Beneficiary's interest in payment under policy insuring individual of whom Beneficiary was a dependent is exempt to extent necessary for support of Beneficiary and dependents.	Proceeds payable to spouse, child, parent or other dependent is wholly exempt from insured's creditors.	215 Ill. Comp. Stat. § 5/238(a), 735.Ill. Comp. Stat. § 5/12-1001(f) and (h)(3)
Indiana	If contract so provides, benefits payable to person other than person effecting policy are wholly exempt from creditors.	If contract so provides, benefits payable to person other than person effecting policy are wholly exempt from creditors.	Ind. Code § 27-2-5-1
Maryland	Proceeds wholly exempt if payable to the spouse, child, or dependent relative of the insured.	Proceeds wholly exempt if payable to the spouse, child, or dependent relative of the insured.	Md. Code Ann., Ins. § 16-111
Massachusetts	Beneficiary's interest in "proceeds" wholly protected from creditors of owner.	None.	Mass. Gen. Laws ch. 175 § 125
Michigan	Proceeds (including cash value) wholly exempt from creditors.	Proceeds wholly exempt.	Mich. Comp. Laws § 500.2207

<b>State Name</b>	<b>Life Insurance Proceeds</b>	<b>Annuity Proceeds</b>	<b>Applicable Section(s)</b>
Missouri	Owner's interest in unmaturred policy (except credit life insurance) wholly exempt; provided that only \$150,000 maximum accrued dividend or interest, or loan value, is exempt (and provided insured is debtor or individual upon whom debtor is dependent).	None.	Mo. Rev. Stat. §§513.430(7) and (8)
New Jersey	Beneficiary's interest in "proceeds and avails" wholly protected from all creditors, provided beneficiary is not owner or insured.	Maximum \$500 per month of benefits under all annuity contracts exempt from creditors.	N.J. Stat. Ann. §§ 17B:24-6 and 17B:24-7
New York	Beneficiary's interest in "proceeds and avails" wholly protected from all creditors, provided beneficiary is not owner or insured. Owner's interest in proceeds and avails of policy insuring another is exempt as against creditors of insured (and owner's own creditors if insured is the owner's spouse).	Court has discretion to order "just and proper amount" paid to creditors with due regard to reasonable requirements of debtor and dependent family; provided maximum \$5,000 exempt if annuity purchased within prior six months of filing bankruptcy.	N.Y. Ins. Law § 3212; N.Y. Debtor & Creditor Law § 283
North Carolina	Proceeds of life insurance payable to the spouse and/or children of the insured are protected from the insured's creditors. Beneficiary's interest in "proceeds" wholly protected from creditors of insured provided Beneficiary is not owner or insured.	Only individual retirement annuity under Code § 408 is exempt.	N.C. Const. § 5; N.C. Gen. Stat. §§ 1C-1601 and 58-58-115
Ohio	"Proceeds or avails" wholly protected from creditors of insured, provided that the Beneficiary is a spouse, child or dependent.	Wholly protected from creditors of annuitant, provided Beneficiary is spouse, child or dependent.	Ohio Rev. Code Ann. § 3911.10
Pennsylvania	Proceeds payable to spouse, child or dependent relative of insured wholly exempt from	Proceeds payable to spouse, child or dependent relative of	42 Pa. Cons. Stat. § 8124(C)

<b>State Name</b>	<b>Life Insurance Proceeds</b>	<b>Annuity Proceeds</b>	<b>Applicable Section(s)</b>
	creditors of insured. Proceeds exempt from own creditors to extent necessary to provide for maximum income or return of \$100 per month.	insured wholly exempt from creditors of insured. Proceeds exempt from own creditors to extent necessary to provide for maximum income or return of \$100 per month.	
Texas	Policy proceeds and cash values wholly protected from all creditors.	Policy proceeds wholly exempt from all creditors.	Tex. Ins. Code § 21.22; §1108.051
Utah	Exemption for proceeds, benefits or avails paid or payable to a spouse or dependent upon death of insured, provided that the contract or policy has been in existence for a continuous unexpired period of one year.	None.	Utah Code Ann. §§ 78B-5-505(1)(a)(xi), (xii), (xiii)

**Foreign Jurisdictions Can Be Considered**

A number of foreign jurisdictions have significant legislation and insurance carrier presence along with favorable regulatory structures that enable carriers to avoid many of the requirements that state insurance commissioners in the United States impose. Notable jurisdictions include Bermuda, the Cayman Islands, the Bahamas, and the Isle of Man.

## **CHAPTER 6**

### **COMMON ISSUES WITH BUYING ANNUITIES**

Variable Annuities are investment based contracts that vary widely with respect to features and complexities.

With a variable annuity contract, the insurance or annuity company takes the monies invested and places them into separate segregated funds which do not belong to the insurance carrier, but are instead held “under the contract” and are thus safe from the insurance carrier’s creditors.

Under a variable annuity contract that qualifies under Internal Revenue Service Code Section 72, income tax on internal build-up in value will be deferred until withdrawals or certain other events occur, but the first dollars paid out normally carry income that has accumulated under the policy under what the industry calls the “last in, first out” (LIFO) rules, unless the contract is annuitized in the year of purchase as discussed in Chapter 2.

The income is taxed as ordinary income, notwithstanding that it may be mostly attributable to capital gains and dividends that would have been taxed at a lower rate if the taxpayer had owned them directly.

For example, if an investor pays \$100,000 for an annuity policy that grows to have a cash surrender value of \$120,000, and then withdraws \$25,000, ordinary income of \$20,000 will be considered to have been received, and the other \$5,000 will be considered to be a return of investment.

Incidentally, the investor needs to be a natural person rather than an entity. If the annuity is not owned by a person or an entity considered to be a natural person for income tax purposes, then all of the tax generated by the income is due every year based on all growth owned value. Further, if the value of the annuity goes down, there is not a reported loss for that year, although, there is no income tax liability until the annuity grows to above the previous year’s value. Advisors, therefore, have to be very careful when integrating variable annuities into tax planning.

With limited exceptions, annuity holders who want to maintain the value of a contract in mutual funds, index arrangements, or otherwise will have to pay income tax on all monies withdrawn, to the extent that growth has occurred, with two exceptions:

1. It is possible to exchange an annuity for multiple annuities that would have equal proportions of “investment in the contract” (basis) and income, and then to liquidate one subsequently acquired contract, leaving the income in the other subsequently acquired contract intact. This requires compliance with the rules of Revenue Procedure 2011-38. This Revenue Procedure is reproduced in Chapter 15 of this book, and discussed in Chapter 7.

2. Lincoln Financial’s i4LIFE<sup>®</sup> product, discussed in Chapter 12 can allow for a portion of each payment from a variable contract to be considered a return of capital that is not taxed. The normal Lincoln Financial Group annuity charges include a 1.3% per year charge for Mortality and Administrative (“M&A”) expenses, and 1.05% per year for the i4LIFE<sup>®</sup> feature. Fund/investment costs are imposed in addition to the above. The agency of record is typically receiving an annual 12B-1 fee of 1/4 of a percent per year, in addition to the sales commissions paid on the product.

Alternatively, investment advisors who provide fee for service management accounts may be able to provide the i4LIFE® product at a reduced cost, with the M&A expense typically being 0.65% per year instead of 1.3% per year.

By comparison, Vanguard and TIAA-CREF have variable annuity products, but without the i4LIFE® feature. Nevertheless, these products have much lower costs, and Vanguard and TIAA-CREF do not compensate their advisors on a commission basis the way that most other carriers do. This may make the advisors less likely to be helpful, but more likely to not “push” a product that might not be well suited for a particular consumer.

Vanguard charges between 0.57% for a typical variable annuity arrangement, and 1.20% more for the Guaranteed Lifetime Withdrawal Benefit (GLWB), with no sales charge or surrender charge.

The GLWB allows the annuitant to receive guaranteed payments for life even if the withdrawals ultimately deplete the accumulated value. Also, at the end of each year the total withdrawal base is assessed, and if it has increased due to market gains, those gains are locked in. If the total withdrawal base has decreased due to market decline, then the base will not change.

Because of the significant confusion and disappointment that have occurred where policyholders did not understand how this works, advisors must closely scrutinize policy language, costs, and “promises made” with these policy features. Commonly they will be described by a salesperson in the following manner: “If you buy this annuity contract, then every year there will be a 7%, or 6%, or 5% minimum value increase or guaranteed lifetime benefit level increase” and it leads an investor to believe that the cash withdrawable value of this contract is going to go up by at least 5% a year. And that is not what any contract that we have seen has said. What the contract actually says is that “in addition to keeping track of your variable mutual fund or index based account we are going to keep track of a separate phantom account, and no matter what, every year the phantom account is going to grow by the greater of how your mutual fund or index does, OR 5%, 6%, or 7%, based upon whatever the contract says, and that phantom account is going to fuel a minimum payment to you that may exceed what the cash value payment will be.” Therefore, the person who buys it thinks that they are getting a 5% rate of return on their main account - no matter what - but instead they are getting a “safety account.”

**10. Disclosures** Withdrawals under your Contract may reduce your Benefit Base. PGB, GMIB, GMDB, and GWBL may not be voluntarily terminated. The charges under the Contract generally apply for the duration of the Contract. I understand that the value of GWBL may be limited if I do not take withdrawals. • For GMIB, PGB and GMDB: For IRA, QP and TSA Contracts: depending on your age, the benefits may be of limited usefulness to you because of federal income tax lifetime required minimum distribution rules which must generally begin after age 70½; distributions that are withdrawn from the Contract may significantly reduce your benefit. You should consult your tax advisor. • GWBL: For IRA, QP and TSA Contracts: Unless you elect our Automatic RMD service and comply with the conditions set forth in the Contract, the Contract may have limited usefulness to you because partial withdrawals to satisfy minimum distribution rules might reduce your Benefit Base. You should consult with your tax advisor to determine if this Contract is appropriate for your circumstances.



**11A. Guaranteed Minimum Income Benefit (GMIB) —**  
*Greater of Roll Up to age 85 or Annual Ratchet to age 85. Guaranteed Minimum Death Benefit (GMDB) elections are also made in this section. Unless "Yes" is checked below, GMIB is declined. Owner issue ages 20–75. Choose One:*

1. **6% GMIB with Annual Reset**  
 Yes, I wish to elect 6% GMIB and Greater of 6% Roll Up to age 85 or Annual Ratchet to age 85 GMDB  
 Yes, I wish to elect 6% GMIB and Annual Ratchet to age 85 GMDB\*  
 Yes, I wish to elect 6% GMIB and Standard GMDB\*

2. **6½% GMIB with Annual Reset**  
 Yes, I wish to elect 6½% GMIB and Greater of 6½% Roll Up to age 85 or Annual Ratchet to age 85 GMDB  
 Yes, I wish to elect 6½% GMIB and Annual Ratchet to age 85 GMDB\*  
 Yes, I wish to elect 6½% GMIB and Standard GMDB\*

\* These four elections restrict your investment Options to the Asset Allocation Investment Options, GIO and/or Special Money Market DCA.

If you elect GMIB, skip to section 12B if you wish to elect EEB. Otherwise, skip to section 14.

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**11B. Principal Guarantee Benefit (PGB)**  
 Unless "Yes" is checked below, PGB is declined.

Yes, I wish to elect the 100% PGB:  
 Owner must allocate funds among the Asset Allocation Investment Options, GIO and/or Special Money Market DCA.

Yes, I wish to elect the 125% PGB:  
 Owner must allocate funds among the AXA Moderate Allocation Investment Option, GIO and/or Special Money Market DCA.

If you elect PCB, you must make a GMDB election in Section 12A.

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**12. Death Benefit Elections** Subject to availability. Except for "Standard" GMDB there is an additional charge for GMDB.  
 If you elect GMIB do not complete section 12A.

**12A. Guaranteed Minimum Death Benefit (GMDB)**  
 If you did not elect GWBL or GMIB, this Section is MANDATORY.  
 Owner Issue Age 0–75

<input type="checkbox"/> Standard; or	<input type="checkbox"/> Standard; or
<input type="checkbox"/> Annual Ratchet to age 85; or	<input type="checkbox"/> Greater of 3% to age 85 or Annual Ratchet to age 85
<input type="checkbox"/> Greater of 6% to age 85 or Annual Ratchet to age 85; or	
<input type="checkbox"/> Greater of 6½% to age 85 or Annual Ratchet to age 85	

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**12B. Earnings Enhancement Benefit (EEB)**  
 Unless "Yes" is checked below, EEB is declined.  
 Yes, I wish to elect the EEB—Owner issue ages 0–75.  
 If you elect EEB, skip to Section 14.

## Vanguard Guaranteed Lifetime Withdrawal Benefit



The illustration above is from an actual policy where the investor checked the box to request, “Yes, I would like this 6.5% Guaranteed Minimum Income Benefit (GMIB) with annual reset.” It would be great to believe that you were getting 6.5% added to the contract every year, would it not?

But what actually happens is that, although the investor believes that his or her variable annuity has a cash surrender value of \$100,000, in reality this is a phantom account, and when he or she starts withdrawing money based upon 6.5% a year, the actual cash account is being reduced and may actually go to zero, leaving the investor's survivors with nothing after the investor dies. Also, while the investor thinks that he or she can pull out 6.5% a year, in reality the percentage may be quite a bit smaller. If you reference the Guaranteed Minimum Income Benefit chart on pages 17-160 and 17-161 below, you can see that at age 65, for example, the "payment rate" is only \$483 per month or approximately 5.8% per year of the phantom account value.

If the beginning balance of the contract is \$1,000,000, then the investor can start taking out \$58,000 per year, but can never get more than that. When the investor dies, no principal remains. So what many of these contracts are actually doing is "annuitizing," whereby in taking advantage of this guarantee you give up your ability to obtain the full value of the principal. Furthermore, in most contracts you also give up the death benefit. Instead you get this stream of payments which will give you a 3% or 4% rate of return at best, if you are lucky enough to live till age 100.

There is some degree of benefit here for somebody who is petrified of the stock market, but it is much less fruitful than many are led to believe.

The TIAA-CREF maximum annual annuity expense charge ranges from 0.45% to 0.70% per year for annuities, and if the Guaranteed Minimum Death Benefit (GMDB) is added, the maximum expenses range from 0.55% to 0.80%, with no sales or surrender charge (see also fee schedule). This GMDB guarantees the right to withdraw up to a pre-defined amount regardless of how the market performs.

# TIAA-CREF Fee Schedule

## Understanding your annuity's charges

The table below shows you how this works. Your charges will also vary depending on whether you elect the Guaranteed Minimum Death Benefit Option (GMDB). This guarantees that if you die before you begin receiving income, your beneficiary will receive the annuity's value or the principal adjusted for any withdrawals, whichever is greater. There is an additional fee for this option, and it can be elected only at time of application.

### Current annual annuity expense charges

#### No Guaranteed Minimum Death Benefit Selected<sup>†</sup>

Annuity Value	\$0 to \$99,999 <sup>‡</sup>	\$100,000 to \$499,999	\$500,000+
1 - 10 years	0.50%	0.35%	0.25%
11+ years	0.10%	0.10%	0.10%

#### Guaranteed Minimum Death Benefit Selected

Annuity Value	\$0 to \$99,999 <sup>‡</sup>	\$100,000 to \$499,999	\$500,000+
1 - 10 years	0.60%	0.45%	0.35%
11+ years	0.20%	0.20%	0.20%

#### Investment fund expenses

The net fund expenses range from 0.09% to 1.35%.

#### Additional charges

If you elect to work with a third-party financial advisor to manage your annuity investments, your financial advisor may deduct a fee from your annuity.

<sup>†</sup> TIAA-CREF Life's Intelligent Variable Annuity's maximum annual annuity expense charge ranges from 0.45% to 0.70%. If the GMDB is selected, the maximum expense charge ranges from 0.55% to 0.80%.

<sup>‡</sup> An annual maintenance fee, \$25.00, will be charged to accounts below \$25,000.

In many situations, the “income guarantees” and “rate of return” features have been purchased at a very high price, with significant confusion and disappointment resulting therefrom.

For example, a policy holder will typically think that a “7% benefit level guarantee” means that the contract investments will earn at least 7% a year, when instead the only “guarantee” is that there will be a “phantom account” that the carrier will keep track of and allow annual payments to be forthcoming for the lifetime of the contract holder beginning in the year that withdrawals begin.

Pages 17-160 and 17-161 show the multiplier factors that one large carrier uses to base minimum payments from the “7% guaranteed roll up” phantom account.

## How to Use Annuity Factors

If the policy holder begins to make annual withdrawals at the age of 70, then the monthly annuity factor for life payments with a refund feature is 5.43 per \$1,000, so the annuity payout per year would be 6.52%  $((5.43 / 1,000) \times 12 = .06516)$ . If the “phantom account” is then shown to be worth \$1,000,000 then \$65,200 per year can come out of the contract for the rest of the contract holder's lifetime, and even if the cash value of the contract ever goes to zero, the payments can continue to come out.

The actual rate of return for this particular contract would not be greater than zero percent until the contract owner lives to age 80, if it was purchased at age 60, and withdrawals start at age 70!

If instead the contract holder wanted to take a joint and survivor annuity, the annuity factor for a 70 year old male and a 70 year old female would be 4.89 per \$1,000. The annuity payout per year would then be 5.87%  $((4.89/1,000) \times 12 = .05868)$ . If the phantom account is then shown to be worth \$1,000,000, then \$58,700 can come out of the contract until the death of the surviving spouse.

The cost of this “guarantee” is commonly 1% per year of the phantom account.

If the phantom account averages \$1,000,000, then this guarantee will cost \$200,000 over a 20-year period!

Additional costs under this contract are typically just under 2.5% per year. Is it all worth it?

**SCHEDULE 1 - ANNUITY FACTORS**

The amounts shown in these tables are the Annuity Factors for each \$1,000 of the Minimum Annuization Value and are based on a 3% Assumed Investment Return.

Age*	Monthly Annuity Factor For Life With No Period Certain			Monthly Annuity Factor For Life With 10 Years Certain			Monthly Annuity Factor For Life With Installment Refund		
	Male	Female	Unisex	Male	Female	Unisex	Male	Female	Unisex
50	\$3.82	\$3.70	\$3.74	\$3.80	\$3.69	\$3.72	\$3.70	\$3.62	\$3.65
51	3.89	3.76	3.80	3.86	3.74	3.78	3.75	3.67	3.70
52	3.95	3.81	3.86	3.92	3.80	3.84	3.81	3.72	3.75
53	4.02	3.88	3.92	3.99	3.86	3.90	3.87	3.78	3.80
54	4.10	3.94	3.99	4.06	3.92	3.96	3.93	3.83	3.86
55	4.18	4.01	4.06	4.13	3.99	4.03	3.99	3.89	3.92
56	4.26	4.08	4.14	4.21	4.06	4.10	4.06	3.95	3.98
57	4.35	4.16	4.22	4.29	4.13	4.18	4.13	4.02	4.05
58	4.44	4.24	4.30	4.38	4.21	4.26	4.20	4.08	4.12
59	4.54	4.33	4.39	4.47	4.29	4.35	4.27	4.16	4.19
60	4.64	4.42	4.49	4.57	4.38	4.44	4.36	4.23	4.27
61	4.76	4.52	4.59	4.67	4.47	4.53	4.44	4.31	4.35
62	4.88	4.63	4.70	4.78	4.57	4.63	4.53	4.39	4.43
63	5.01	4.74	4.82	4.89	4.67	4.74	4.62	4.48	4.52
64	5.15	4.86	4.94	5.01	4.78	4.85	4.72	4.57	4.62
65	5.30	4.98	5.08	5.14	4.89	4.85	4.83	4.67	4.72
66	5.46	5.12	5.22	5.27	5.02	5.09	4.94	4.78	4.82
67	5.63	5.27	5.37	5.41	5.14	5.22	5.05	4.89	4.94
68	5.81	5.42	5.54	5.55	5.28	5.36	5.17	5.00	5.05
69	6.00	5.59	5.71	5.70	5.42	5.51	5.30	5.13	5.18
70	6.21	5.78	5.90	5.86	5.58	5.66	5.43	5.26	5.31
71	6.43	5.97	6.11	6.02	5.74	5.82	5.58	5.39	5.45
72	6.66	6.19	6.33	6.18	5.90	5.99	5.72	5.54	5.59
73	6.91	6.42	6.56	6.35	6.08	6.16	5.88	5.70	5.75
74	7.18	6.67	6.82	6.53	6.26	6.34	6.05	5.86	5.92
75	7.46	6.94	7.09	6.70	6.45	6.53	6.22	6.04	6.09
76	7.77	7.23	7.39	6.88	6.65	6.72	6.40	6.22	6.27
77	8.10	7.55	7.71	7.07	6.85	6.91	6.60	6.42	6.47
78	8.45	7.89	8.05	7.25	7.05	7.11	6.80	6.63	6.68
79	8.83	8.26	8.43	7.43	7.26	7.31	7.01	6.85	6.89
80	9.23	8.66	8.83	7.61	7.46	7.51	7.24	7.08	7.13
81	9.66	9.10	9.27	7.79	7.66	7.70	7.47	7.33	7.37
82	10.13	9.57	9.74	7.97	7.86	7.89	7.72	7.59	7.63
83	10.62	10.09	10.24	8.13	8.05	8.07	7.98	7.86	7.90
84	11.15	10.64	10.79	8.29	8.23	8.25	8.26	8.15	8.18
85	11.72	11.24	11.38	8.44	8.40	8.41	8.55	8.45	8.48

**Monthly Annuity Factor For Joint and Full Survivor**

Age of Male Annuitant*	Age of Female Annuitant*						
	15 Years Less Than Male	12 Years Less Than Male	9 Years Less Than Male	6 Years Less Than Male	3 Years Less Than Male	Same As Male	3 Years More Than Male
50	\$3.06	\$3.12	\$3.19	\$3.25	\$3.31	\$3.38	\$3.44
55	3.20	3.27	3.35	3.44	3.52	3.61	3.69
60	3.37	3.47	3.57	3.68	3.79	3.91	4.02
65	3.59	3.72	3.86	4.01	4.16	4.32	4.47
70	3.88	4.06	4.25	4.45	4.67	4.89	5.11

**Monthly Annuity Factor For Unisex Joint and Full Survivor**

Age of First Annuitant*	Age of Joint Annuitant*						
	15 Years Less Than First	12 Years Less Than First	9 Years Less Than First	6 Years Less Than First	3 Years Less Than First	Same As First	3 Years More Than First
50	\$3.07	\$3.13	\$3.19	\$3.25	\$3.31	\$3.37	\$3.43
55	3.20	3.28	3.36	3.44	3.52	3.60	3.67
60	3.38	3.48	3.58	3.68	3.79	3.89	4.00
65	3.61	3.73	3.87	4.01	4.16	4.30	4.44
70	3.90	4.07	4.26	4.46	4.66	4.86	5.05

\*Adjusted Age nearest birthday

Dollar amounts of monthly, quarterly, semi-annual, and annual factors not shown in the above tables will be calculated on the same basis as those shown and may be obtained from Us.

We routinely run spreadsheets to show our clients how these products work, and we typically account for three different scenarios. The first section is the actual annuity contract cash value, and columns showing its growth, and reduction by fees and costs. The second section is to illustrate the guarantee feature (the “phantom account”), and what the rate of return occurs if the “guaranteed payments” feature has to be used because the cash value of the contract runs out. The third section of the illustration shows what would have happened if the same amount had been invested in bonds and mutual funds, with comparable rates of return and typical costs, which are considerably lower than the charges imposed by variable annuity carriers.

On an average, variable annuity costs are typically between 2% and 4% a year. This is quite high, when compared to the typical cost for mutual funds and non-commissioned annuity products. Looking at the examples on pages 17-162 through 17-164, there is an administrative fee of \$30 a year, and an account charge of 1.30% a year. Also added is the guaranteed minimum income benefit charge of 1%, and that is not 1% of the actual cash value, but 1% of the phantom account value. Your cash value is being reduced by your phantom account value, so that is really 2% in this example. Then there is the death benefit charge of .60%, and again that is on the phantom account value, and keep in mind that you are unlikely to ever receive the full value of your phantom account. All of this is usually very unclear to investors, and they often have a salesperson pushing their product hard. The investor might understand a flat 6% guarantee from a salesperson, but advisors

need to be able to read between the lines. An annuity prospectus is not always clear or comprehensible.

Suppose an investor's actual account is worth \$164,000 after 10 years, with an average market increase of 4% a year, but the phantom account is worth \$251,000. Every month the investor gets a statement saying the account is worth \$164,000, but the minimum guarantee income account is \$251,000. Then the investor comes into our office and says "I have \$251,000 in this annuity." If the investor had chosen a mutual fund with the same mix, the investment would probably be worth closer to \$210,000, rather than a phantom \$251,000 but an actual \$164,000.

In the Forbes.com article "9 Reasons You Need to Avoid Variable Annuities" author Eve Kaplan says "[d]isclosure to individuals – at the least the clients I work with - is very poor. I typically see a lot of confusion on the part of clients who bought variable annuities. These are complex instruments with many moving parts that aren't always adequately explained (or even understood) by the seller. Folks who buy annuities don't understand the tax ins and outs and often are told variable annuities are 'safe' etc."

Investor in XYZ Annuity  
 Annuitize at Age 70 with 5 Years Guaranteed  
 Market - 4% Phantom - 5%  
 Age 44

Under this particular scenario the market is increasing at a rate of 4%, and the phantom account is increasing at contract will be annuitized in 2040 at the age of 70. Once the contract is annuitized the Death Benefit rider is 1 the Death Benefit is ZERO.

		Annuity Contract																	
Year	Age	Annuity Contract Beginning Balance	Yearly Gain 4%	Annual Admin of \$30	Daily Separate Account Charge 1.30%/Year	GMIB** - 1.00%/Year	GMIB % of Annuity Contract	GMDB 0.60%/Year	GMDB % of Annuity Contract	Subaccount Fee Average (0.8%)	Total Annual Expenses	Annual Cost Percentage	Net Gain or Loss per Year	Annuity Contract Ending Balance	Phantom Account Beginning Balance	Yearly Phantom Account Gain	Phantom Account Ending Balance	Annual Payments	Total Payments
2014	44	\$ 529,614	\$ 21,185	\$ (30)	\$ (6,885)	\$ (5,374)	-1.01%	\$ (3,224)	-0.61%	\$ (4,237)	\$ (19,750)	-3.73%	\$ 1,435	\$ 531,049	\$ 537,354	\$ 26,868	\$ 564,222		
2015	45	\$ 531,049	\$ 21,242	\$ (30)	\$ (6,904)	\$ (5,642)	-1.06%	\$ (3,385)	-0.64%	\$ (4,248)	\$ (20,210)	-3.81%	\$ 1,032	\$ 532,081	\$ 564,222	\$ 28,211	\$ 592,433		
2016	46	\$ 532,081	\$ 21,283	\$ (30)	\$ (6,917)	\$ (5,924)	-1.11%	\$ (3,555)	-0.67%	\$ (4,257)	\$ (20,683)	-3.89%	\$ 601	\$ 532,682	\$ 592,433	\$ 29,622	\$ 622,054		
2017	47	\$ 532,682	\$ 21,307	\$ (30)	\$ (6,925)	\$ (6,221)	-1.17%	\$ (3,732)	-0.70%	\$ (4,261)	\$ (21,169)	-3.97%	\$ 138	\$ 532,820	\$ 622,054	\$ 31,103	\$ 653,157		\$ -
2018	48	\$ 532,820	\$ 21,313	\$ (30)	\$ (6,927)	\$ (6,532)	-1.23%	\$ (3,919)	-0.74%	\$ (4,263)	\$ (21,670)	-4.07%	\$ (357)	\$ 532,463	\$ 653,157	\$ 32,658	\$ 685,815		\$ -
2019	49	\$ 532,463	\$ 21,299	\$ (30)	\$ (6,922)	\$ (6,858)	-1.29%	\$ (4,115)	-0.77%	\$ (4,260)	\$ (22,185)	-4.17%	\$ (886)	\$ 531,577	\$ 685,815	\$ 34,291	\$ 720,106		\$ -
2020	50	\$ 531,577	\$ 21,263	\$ (30)	\$ (6,911)	\$ (7,201)	-1.35%	\$ (4,321)	-0.81%	\$ (4,253)	\$ (22,715)	-4.27%	\$ (1,452)	\$ 530,125	\$ 720,106	\$ 36,005	\$ 756,111		\$ -
2021	51	\$ 530,125	\$ 21,205	\$ (30)	\$ (6,892)	\$ (7,561)	-1.43%	\$ (4,537)	-0.86%	\$ (4,241)	\$ (23,260)	-4.39%	\$ (2,055)	\$ 528,070	\$ 756,111	\$ 37,806	\$ 793,917		\$ -
2022	52	\$ 528,070	\$ 21,123	\$ (30)	\$ (6,865)	\$ (7,939)	-1.50%	\$ (4,763)	-0.90%	\$ (4,225)	\$ (23,822)	-4.51%	\$ (2,699)	\$ 525,370	\$ 793,917	\$ 39,696	\$ 833,612		\$ -
2023	53	\$ 525,370	\$ 21,015	\$ (30)	\$ (6,830)	\$ (8,336)	-1.59%	\$ (5,002)	-0.95%	\$ (4,203)	\$ (24,401)	-4.64%	\$ (3,386)	\$ 521,985	\$ 833,612	\$ 41,681	\$ 875,293		\$ -
2024	54	\$ 521,985	\$ 20,879	\$ (30)	\$ (6,786)	\$ (8,753)	-1.68%	\$ (5,252)	-1.01%	\$ (4,176)	\$ (24,996)	-4.79%	\$ (4,117)	\$ 517,888	\$ 875,293	\$ 43,765	\$ 919,058		\$ -
2025	55	\$ 517,888	\$ 20,715	\$ (30)	\$ (6,732)	\$ (9,191)	-1.77%	\$ (5,514)	-1.08%	\$ (4,143)	\$ (25,610)	-4.95%	\$ (4,895)	\$ 512,972	\$ 919,058	\$ 45,953	\$ 965,011		\$ -
2026	56	\$ 512,972	\$ 20,519	\$ (30)	\$ (6,669)	\$ (9,650)	-1.88%	\$ (5,790)	-1.13%	\$ (4,104)	\$ (26,243)	-5.12%	\$ (5,724)	\$ 507,249	\$ 965,011	\$ 48,251	\$ 1,013,261		\$ -
2027	57	\$ 507,249	\$ 20,290	\$ (30)	\$ (6,594)	\$ (10,133)	-2.00%	\$ (6,080)	-1.20%	\$ (4,058)	\$ (26,894)	-5.30%	\$ (6,604)	\$ 500,644	\$ 1,013,261	\$ 50,663	\$ 1,063,924		\$ -
2028	58	\$ 500,644	\$ 20,026	\$ (30)	\$ (6,500)	\$ (10,639)	-2.13%	\$ (6,384)	-1.28%	\$ (4,005)	\$ (27,566)	-5.51%	\$ (7,541)	\$ 493,104	\$ 1,063,924	\$ 53,196	\$ 1,117,320		\$ -
2029	59	\$ 493,104	\$ 19,724	\$ (30)	\$ (6,410)	\$ (11,171)	-2.27%	\$ (6,703)	-1.36%	\$ (3,945)	\$ (28,259)	-5.73%	\$ (8,535)	\$ 484,569	\$ 1,117,320	\$ 55,856	\$ 1,174,976		\$ -
2030	60	\$ 484,569	\$ 19,383	\$ (30)	\$ (6,299)	\$ (11,730)	-2.42%	\$ (7,038)	-1.45%	\$ (3,877)	\$ (28,974)	-5.98%	\$ (9,591)	\$ 474,978	\$ 1,174,976	\$ 58,649	\$ 1,234,625		\$ -
2031	61	\$ 474,978	\$ 18,999	\$ (30)	\$ (6,175)	\$ (12,316)	-2.59%	\$ (7,390)	-1.56%	\$ (3,800)	\$ (29,711)	-6.26%	\$ (10,711)	\$ 464,266	\$ 1,234,625	\$ 61,581	\$ 1,297,207		\$ -
2032	62	\$ 464,266	\$ 18,571	\$ (30)	\$ (6,035)	\$ (12,932)	-2.79%	\$ (7,759)	-1.67%	\$ (3,714)	\$ (30,471)	-6.56%	\$ (11,900)	\$ 452,366	\$ 1,297,207	\$ 64,660	\$ 1,357,867		\$ -
2033	63	\$ 452,366	\$ 18,095	\$ (30)	\$ (5,881)	\$ (13,579)	-3.00%	\$ (8,147)	-1.80%	\$ (3,619)	\$ (31,256)	-6.91%	\$ (13,161)	\$ 439,305	\$ 1,357,867	\$ 67,893	\$ 1,425,760		\$ -
2034	64	\$ 439,305	\$ 17,568	\$ (30)	\$ (5,710)	\$ (14,258)	-3.25%	\$ (8,555)	-1.95%	\$ (3,514)	\$ (32,065)	-7.30%	\$ (14,497)	\$ 424,708	\$ 1,425,760	\$ 71,288	\$ 1,497,048		\$ -
2035	65	\$ 424,708	\$ 16,988	\$ (30)	\$ (5,521)	\$ (14,970)	-3.52%	\$ (8,982)	-2.11%	\$ (3,398)	\$ (32,902)	-7.75%	\$ (15,913)	\$ 408,795	\$ 1,497,048	\$ 74,852	\$ 1,571,901		\$ -
2036	66	\$ 408,795	\$ 16,352	\$ (30)	\$ (5,314)	\$ (15,719)	-3.85%	\$ (9,431)	-2.31%	\$ (3,270)	\$ (33,765)	-8.26%	\$ (17,413)	\$ 391,381	\$ 1,571,901	\$ 78,595	\$ 1,650,496		\$ -
2037	67	\$ 391,381	\$ 15,655	\$ (30)	\$ (5,088)	\$ (16,505)	-4.22%	\$ (9,903)	-2.53%	\$ (3,131)	\$ (34,657)	-8.86%	\$ (19,002)	\$ 372,380	\$ 1,650,496	\$ 82,525	\$ 1,733,020		\$ -
2038	68	\$ 372,380	\$ 14,895	\$ (30)	\$ (4,841)	\$ (17,330)	-4.65%	\$ (10,398)	-2.79%	\$ (2,979)	\$ (35,578)	-9.55%	\$ (20,663)	\$ 351,697	\$ 1,733,020	\$ 86,651	\$ 1,819,671		\$ -
2039	69	\$ 351,697	\$ 14,060	\$ (30)	\$ (4,572)	\$ (18,197)	-5.17%	\$ (10,918)	-3.10%	\$ (2,814)	\$ (36,530)	-10.39%	\$ (22,463)	\$ 329,234	\$ 1,819,671	\$ 90,964	\$ 1,910,635		\$ -

t a rate of 5%. The terminated, meaning

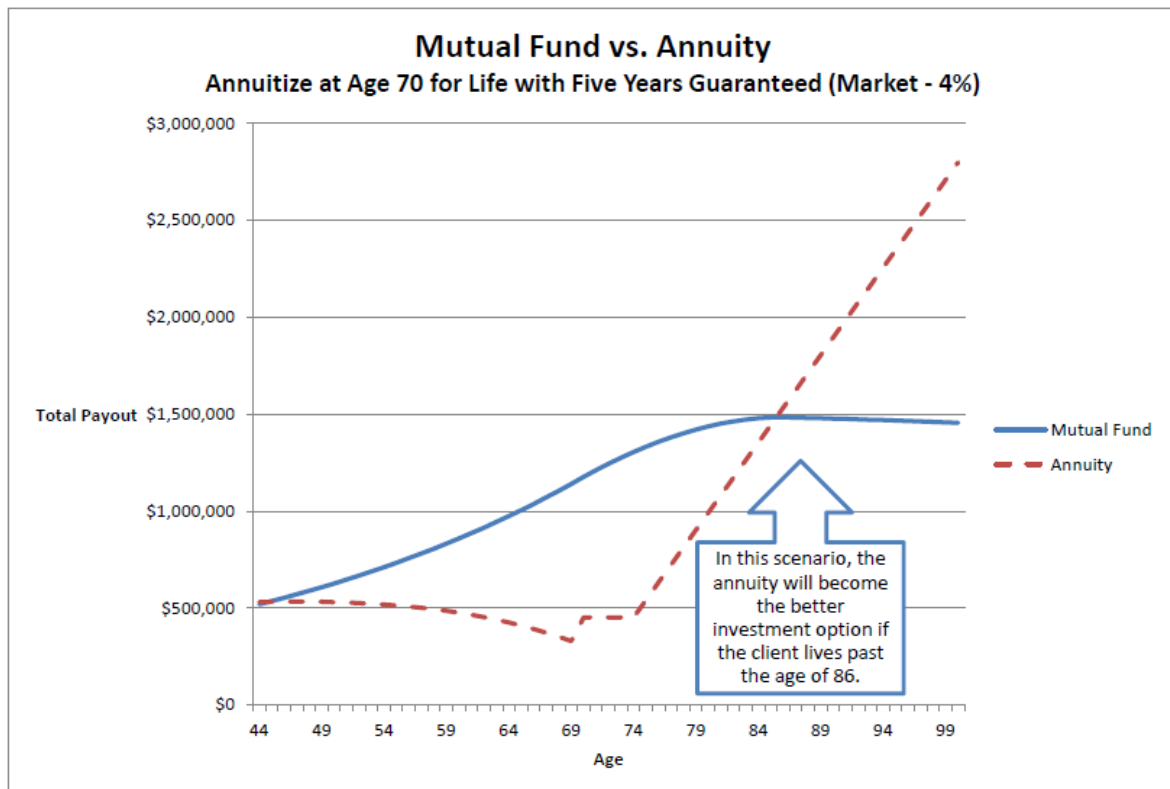
Balanced Mutual Fund																		
Death Benefit	Year	Age	Rate of Return on Current Cash Value	Rate of Return on Phantom Account Value	Rate of Return on Original Investment	Likelihood of Having Died	Year	Age	Mutual Fund Value*	Growth at 4%	Fees at 0.8%	Net Investment	Annual Payments	Difference Between Mutual Fund and Annuity (Mutual Fund minus Annuity)	Year	Age	Likelihood of Having Died	
\$ 564,222	2014	44				0.06%	2014	44	\$ 502,584	\$ 522,687	\$ (4,021)	\$ 516,667	\$ -	\$ (12,382)	2014	44	0.06%	
\$ 592,433	2015	45				0.14%	2015	45	\$ 518,667	\$ 539,413	\$ (4,149)	\$ 535,264	\$ -	\$ 3,163	2015	45	0.14%	
\$ 622,054	2016	46				0.24%	2016	46	\$ 535,264	\$ 556,675	\$ (4,282)	\$ 552,392	\$ -	\$ 19,710	2016	46	0.24%	
\$ 653,157	2017	47				0.36%	2017	47	\$ 552,392	\$ 574,488	\$ (4,419)	\$ 570,069	\$ -	\$ 37,249	2017	47	0.36%	
\$ 685,615	2018	48				0.51%	2018	48	\$ 570,069	\$ 592,872	\$ (4,561)	\$ 588,311	\$ -	\$ 55,848	2018	48	0.51%	
\$ 720,106	2019	49				0.68%	2019	49	\$ 588,311	\$ 611,844	\$ (4,706)	\$ 607,137	\$ -	\$ 75,560	2019	49	0.68%	
\$ 756,111	2020	50				0.89%	2020	50	\$ 607,137	\$ 631,423	\$ (4,857)	\$ 626,566	\$ -	\$ 96,440	2020	50	0.89%	
\$ 793,917	2021	51				1.13%	2021	51	\$ 626,566	\$ 651,628	\$ (5,013)	\$ 646,616	\$ -	\$ 118,546	2021	51	1.13%	
\$ 833,612	2022	52				1.40%	2022	52	\$ 646,616	\$ 672,480	\$ (5,173)	\$ 667,307	\$ -	\$ 141,937	2022	52	1.40%	
\$ 875,293	2023	53				1.71%	2023	53	\$ 667,307	\$ 694,000	\$ (5,338)	\$ 688,661	\$ -	\$ 166,677	2023	53	1.71%	
\$ 919,058	2024	54				2.07%	2024	54	\$ 688,661	\$ 716,208	\$ (5,509)	\$ 710,698	\$ -	\$ 192,831	2024	54	2.07%	
\$ 965,011	2025	55				2.48%	2025	55	\$ 710,698	\$ 739,126	\$ (5,686)	\$ 733,441	\$ -	\$ 220,468	2025	55	2.48%	
\$ 1,013,261	2026	56				2.95%	2026	56	\$ 733,441	\$ 762,778	\$ (5,866)	\$ 756,911	\$ -	\$ 249,662	2026	56	2.95%	
\$ 1,063,924	2027	57				3.46%	2027	57	\$ 756,911	\$ 787,187	\$ (6,055)	\$ 781,132	\$ -	\$ 280,488	2027	57	3.46%	
\$ 1,117,120	2028	58				4.03%	2028	58	\$ 781,132	\$ 812,377	\$ (6,249)	\$ 806,128	\$ -	\$ 313,025	2028	58	4.03%	
\$ 1,172,976	2029	59				4.65%	2029	59	\$ 806,128	\$ 838,373	\$ (6,449)	\$ 831,924	\$ -	\$ 347,536	2029	59	4.65%	
\$ 1,231,625	2030	60				5.35%	2030	60	\$ 831,924	\$ 865,201	\$ (6,655)	\$ 858,546	\$ -	\$ 383,560	2030	60	5.35%	
\$ 1,293,207	2031	61				6.14%	2031	61	\$ 858,546	\$ 892,888	\$ (6,868)	\$ 886,019	\$ -	\$ 421,753	2031	61	6.14%	
\$ 1,357,867	2032	62				7.02%	2032	62	\$ 886,019	\$ 921,460	\$ (7,088)	\$ 914,372	\$ -	\$ 462,006	2032	62	7.02%	
\$ 1,425,760	2033	63				7.99%	2033	63	\$ 914,372	\$ 950,947	\$ (7,315)	\$ 943,632	\$ -	\$ 504,427	2033	63	7.99%	
\$ 1,497,048	2034	64				9.07%	2034	64	\$ 943,632	\$ 981,377	\$ (7,549)	\$ 973,828	\$ -	\$ 549,120	2034	64	9.07%	
\$ 1,571,901	2035	65				10.24%	2035	65	\$ 973,828	\$ 1,012,781	\$ (7,791)	\$ 1,004,991	\$ -	\$ 596,196	2035	65	10.24%	
\$ 1,650,496	2036	66				11.52%	2036	66	\$ 1,004,991	\$ 1,045,190	\$ (8,040)	\$ 1,037,150	\$ -	\$ 645,769	2036	66	11.52%	
\$ 1,733,020	2037	67				12.91%	2037	67	\$ 1,037,150	\$ 1,078,636	\$ (8,297)	\$ 1,070,339	\$ -	\$ 697,959	2037	67	12.91%	
\$ 1,819,671	2038	68				14.44%	2038	68	\$ 1,070,339	\$ 1,113,153	\$ (8,563)	\$ 1,104,590	\$ -	\$ 752,893	2038	68	14.44%	
\$ 1,910,655	2039	69				16.21%	2039	69	\$ 1,104,590	\$ 1,148,774	\$ (8,837)	\$ 1,139,937	\$ -	\$ 810,703	2039	69	16.21%	
2040	70	\$ 329,234	\$ 13,169	\$ (4,200)	\$ (19,107)	-5.80%	\$ (11,464)	-3.45%	\$ (2,634)	\$ (37,514)	-11.39%	\$ (24,345)	\$ 304,889	\$ 1,910,655	\$ 95,533	\$ 2,006,188	\$ 90,278	\$ 90,278
2041	71	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 90,278	\$ 180,557
2042	72	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 90,278	\$ 270,835
2043	73	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 90,278	\$ 361,114
2044	74	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 90,278	\$ 451,392
2045	75	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 90,278	\$ 541,671
2046	76	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 90,278	\$ 631,949
2047	77	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 90,278	\$ 722,228
2048	78	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 90,278	\$ 812,506
2049	79	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 90,278	\$ 902,784
2050	80	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 90,278	\$ 993,063
2051	81	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 90,278	\$ 1,083,341
2052	82	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 90,278	\$ 1,173,620
2053	83	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 90,278	\$ 1,263,898
2054	84	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 90,278	\$ 1,354,177
2055	85	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 90,278	\$ 1,444,455
2056	86	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 90,278	\$ 1,534,734
2057	87	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 90,278	\$ 1,625,012
2058	88	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 90,278	\$ 1,715,291
2059	89	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 90,278	\$ 1,805,569
2060	90	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 90,278	\$ 1,895,847
2061	91	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 90,278	\$ 1,986,126
2062	92	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 90,278	\$ 2,076,404
2063	93	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 90,278	\$ 2,166,683
2064	94	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 90,278	\$ 2,256,961
2065	95	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 90,278	\$ 2,347,240
2066	96	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 90,278	\$ 2,437,518
2067	97	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 90,278	\$ 2,527,797
2068	98	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 90,278	\$ 2,618,075
2069	99	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 90,278	\$ 2,708,353
2070	100	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 90,278	\$ 2,798,632

\*The amount invested in the mutual fund takes into consideration the surrender charge that will be applied for withdrawing the cash value of the annuity contract

\\Law Clerks\Brandon Ketrone\Ann\Annuity Book\Annuity For Life with Five Years Guaranteed (Market 4% Phantom 3%) AGE 70 STERILIZED.us\Age 70



2040	70			18.12%	2040	70	\$	1,139,937	\$	1,185,934	\$	(9,119)	\$	1,086,136	\$	90,278	\$	1,086,136	2040	70	18.12%	
2041	71			20.18%	2041	71	\$	1,086,136	\$	1,129,582	\$	(8,689)	\$	1,030,614	\$	90,278	\$	1,030,614	2041	71	20.18%	
2042	72			22.43%	2042	72	\$	1,030,614	\$	1,071,839	\$	(8,245)	\$	973,316	\$	90,278	\$	973,316	2042	72	22.43%	
2043	73			24.85%	2043	73	\$	973,316	\$	1,012,248	\$	(7,787)	\$	914,183	\$	90,278	\$	914,183	2043	73	24.85%	
2044	74	-0.46%	-0.52%	-0.79%	27.45%	2044	74	\$	914,183	\$	950,751	\$	(7,313)	\$	853,159	\$	90,278	\$	853,159	2044	74	27.45%
2045	75	0.07%	0.03%	0.12%	30.22%	2045	75	\$	853,159	\$	887,285	\$	(6,825)	\$	790,181	\$	90,278	\$	790,181	2045	75	30.22%
2046	76	0.59%	0.53%	0.97%	33.17%	2046	76	\$	790,181	\$	821,788	\$	(6,321)	\$	725,189	\$	90,278	\$	725,189	2046	76	33.17%
2047	77	1.07%	1.01%	1.78%	36.31%	2047	77	\$	725,189	\$	754,196	\$	(5,802)	\$	658,116	\$	90,278	\$	658,116	2047	77	36.31%
2048	78	1.53%	1.46%	2.55%	39.65%	2048	78	\$	658,116	\$	684,441	\$	(5,265)	\$	588,897	\$	90,278	\$	588,897	2048	78	39.65%
2049	79	1.96%	1.89%	3.27%	43.19%	2049	79	\$	588,897	\$	612,453	\$	(4,711)	\$	517,464	\$	90,278	\$	517,464	2049	79	43.19%
2050	80	2.37%	2.29%	3.96%	46.92%	2050	80	\$	517,464	\$	538,162	\$	(4,140)	\$	443,744	\$	90,278	\$	443,744	2050	80	46.92%
2051	81	2.75%	2.67%	4.61%	50.80%	2051	81	\$	443,744	\$	461,494	\$	(3,550)	\$	367,665	\$	90,278	\$	367,665	2051	81	50.80%
2052	82	3.12%	3.04%	5.24%	54.79%	2052	82	\$	367,665	\$	382,372	\$	(2,941)	\$	289,152	\$	90,278	\$	289,152	2052	82	54.79%
2053	83	3.47%	3.38%	5.83%	58.85%	2053	83	\$	289,152	\$	300,718	\$	(2,313)	\$	208,127	\$	90,278	\$	208,127	2053	83	58.85%
2054	84	3.80%	3.71%	6.39%	62.94%	2054	84	\$	208,127	\$	216,452	\$	(1,665)	\$	124,508	\$	90,278	\$	124,508	2054	84	62.94%
2055	85	4.11%	4.02%	6.93%	67.01%	2055	85	\$	124,508	\$	129,489	\$	(996)	\$	38,214	\$	90,278	\$	38,214	2055	85	67.01%
2056	86	4.41%	4.32%	7.45%	71.03%	2056	86	\$	38,214	\$	39,743	\$	(306)	\$	(50,841)	\$	90,278	\$	(50,841)	2056	86	71.03%
2057	87	4.70%	4.60%	7.94%	74.93%	2057	87	\$	(50,841)	\$	(52,875)	\$	407	\$	(52,468)	\$	-	\$	(142,747)	2057	87	74.93%
2058	88	4.98%	4.87%	8.41%	78.64%	2058	88	\$	(52,468)	\$	(54,567)	\$	420	\$	(54,147)	\$	-	\$	(234,704)	2058	88	78.64%
2059	89	5.24%	5.13%	8.86%	82.10%	2059	89	\$	(54,147)	\$	(56,313)	\$	433	\$	(55,880)	\$	-	\$	(326,715)	2059	89	82.10%
2060	90	5.49%	5.38%	9.29%	85.25%	2060	90	\$	(55,880)	\$	(58,115)	\$	447	\$	(57,668)	\$	-	\$	(418,782)	2060	90	85.25%
2061	91	5.73%	5.62%	9.71%	88.04%	2061	91	\$	(57,668)	\$	(59,975)	\$	461	\$	(59,514)	\$	-	\$	(510,906)	2061	91	88.04%
2062	92	5.96%	5.85%	10.11%	90.47%	2062	92	\$	(59,514)	\$	(61,894)	\$	476	\$	(61,418)	\$	-	\$	(603,089)	2062	92	90.47%
2063	93	6.18%	6.06%	10.49%	92.55%	2063	93	\$	(61,418)	\$	(63,875)	\$	491	\$	(63,383)	\$	-	\$	(695,333)	2063	93	92.55%
2064	94	6.40%	6.27%	10.86%	94.30%	2064	94	\$	(63,383)	\$	(65,919)	\$	507	\$	(65,412)	\$	-	\$	(787,639)	2064	94	94.30%
2065	95	6.60%	6.48%	11.22%	95.72%	2065	95	\$	(65,412)	\$	(68,028)	\$	523	\$	(67,505)	\$	-	\$	(880,011)	2065	95	95.72%
2066	96	6.80%	6.67%	11.56%	96.85%	2066	96	\$	(67,505)	\$	(70,205)	\$	540	\$	(69,665)	\$	-	\$	(972,450)	2066	96	96.85%
2067	97	6.99%	6.86%	11.89%	97.73%	2067	97	\$	(69,665)	\$	(72,452)	\$	557	\$	(71,894)	\$	-	\$	(1,064,957)	2067	97	97.73%
2068	98	7.17%	7.04%	12.21%	98.40%	2068	98	\$	(71,894)	\$	(74,770)	\$	575	\$	(74,195)	\$	-	\$	(1,157,536)	2068	98	98.40%
2069	99	7.35%	7.21%	12.52%	98.90%	2069	99	\$	(74,195)	\$	(77,163)	\$	594	\$	(76,569)	\$	-	\$	(1,250,189)	2069	99	98.90%
2070	100	7.52%	7.38%	12.82%	99.26%	2070	100	\$	(76,569)	\$	(79,632)	\$	613	\$	(79,019)	\$	-	\$	(1,342,918)	2070	100	99.26%



**Letter to Client Who Has Misunderstood the Guaranteed Nature of a Variable Annuity Product That Has Been Costing Over 3% per Year from the Cash Value to Maintain:**

Dear Client:

I am writing you this letter to describe the attached Guaranteed Optional Chosen Benefits pages that were provided to me as part of your variable annuity contract. There is no charge for writing this letter.

Please note that the Guaranteed Minimum Annual Income Benefit (GMAIB) is an artificial level of contract value that is calculated by compounding your contributions, adjusted for any withdrawals, at 6.5% annually. There is an annual “ratchet up” reset feature based upon the highest Annuity Account Value on each contract anniversary date.

They do not give you the highest value for the year, but instead base this upon the actual market value on each anniversary date.

Typically, the highest value for a particular year will be significantly more than a value given for a specific anniversary date.

It may make good sense to take out 6.5% of the GMAIB amount each year to have a stable GMAIB level until the cash value of the policy goes to zero.

Once the cash value of the policy goes to zero then you would not be able to receive more money out of the contract without electing to “annuitize” the contract.

Once you “annuitize” the contract your guaranteed death benefit disappears, and you receive a set annual amount each year for the rest of your life (or a slightly smaller amount that will pay out for at least ten years even if you die within ten years of making the election).

Once you annuitize you lose all ability to withdraw anything beyond the annual payment, and nothing will be inherited upon your death.

The annuity is not based upon 6.5% of the GMAIB.

It is based upon a percentage of the GMAIB, as indicated on the attached Table of Guaranteed Annuity Payments.

At age 70 this would be based upon 4.73% of the then applicable GMAIB, and becomes a fixed annual dollar amount that never increases.

If you made the election at age 75 they would pay you based upon 5.24% of the then applicable GMAIB.

Therefore, if your GMAIB level is \$1,000,000 and you elect to annuitize at age 75, you would only receive \$54,200 per year for the rest of your life, and would never receive any “principal” or the ability to receive \$65,000 a year.

Please note that the first attached page indicates that in Year 10 the GMAIB would be \$61,720.28.

The amount of \$600,000 that you invested growing at 6.5% a year for ten years would be worth \$1,126,282.30.

\$61,720.28 divided by \$1,126,282.30 is 5.48%.

If this was truly a 6.5% rate of return then you would receive 6.5% of \$1,126,282.30, which would be \$73,208.35 per year, plus whatever principal you might withdraw.

Another way of looking at this is that at \$61,720.28 a year you would have to live more than 18 years to even get your principal of \$1,126,282.30 back, without interest.

The next page describes the Guaranteed Minimum Death Benefit. This is generally based upon the GMAIB amount described previously, except that it disappears if and when you annuitize. It would therefore seem that it would never make sense to annuitize unless or until you run out of cash value.

By copy of this letter to John Broker, I am asking for input, comments, or suggestions on the above.

John's firm is being compensated annually based upon 24/100 of 1% of the Guaranteed Minimum Death Benefit, and if you move this to a no-load annuity product it would be appropriate to compensate him in another manner.

If this were my situation I would be looking at how to best move out of this annuity contract into a less expensive arrangement.

Best personal regards,  
Attorney

### **Income Guarantees**

Many state registered carriers provide "minimum withdrawal right guarantees" that comfort investors with respect to the risk of losing investment value in underlying subaccount investments, in case of a stock market crash or severe market decline. However, these guarantees are commonly misunderstood, even by those who sell them. Advisors should take great care to be sure that the guarantees are understood and not exaggerated or overused.

A common mistake or deceptive practice involves advertised claims that variable annuity products come with "income guarantees." One would think that the term "income guarantee" means that the investment in the contract is guaranteed to provide a certain amount of income that is added to the investment in the contract. The vast majority, if not all, of the present "income guarantee" products now offered are instead merely "payment guarantee" products which provide that a relatively small minimum annual payment amount will continue if and when the annuity contract runs out of assets. While the owner may believe that they are receiving "guaranteed income", they are actually receiving monies from the investments under the contract, and the carrier will provide its own money only after the entire value of the contract has run out. This can result in no inheritance whatsoever being received by the clients' desired beneficiaries unless additional guarantees that cost additional percentages of value of the contract each year have been purchased that will not be used.

Contracts that promise “double the guarantee” payments for circumstances where long-term care insurance would be needed are most often allowing double the payment to exhaust the investment in the contract before the carrier makes any contribution. Given that these contracts can cost 3.5% or more per year and often require that 25% of the portfolio be invested in bond funds, many consumers and advisors do not understand what is actually happening.

Sales commissions can influence the judgment of financial advisors. Many professionals who work in the industry notice that weaker, smaller, or more aggressive carriers pay higher commissions to sales people and make less than conservative claims. Products offered by these carriers often involve high charges and more financial risk than the client is aware of. There are products openly advertised in the National Underwriter magazine that pays a 6.25% commission to agencies that sell them, and have only “B” or lower credit ratings from A.M. Best and up to a seven year 9% surrender charge.

In many situations, annuity contracts are sold because the sales representative is licensed to sell life insurance and annuity products, but not mutual funds. It takes a Series 6 license issued by the Financial Industry Regulatory Authority, Inc. (FINRA) to sell an annuity contract or life insurance contract, and a Series 7 license to sell stocks and mutual funds. The Series 7 license is more difficult to obtain, as it requires a more extensive and longer exam and a higher score to pass than what is needed for the Series 6 license<sup>8</sup>. It seems to the authors that the increased complexity that variable annuity and life insurance products present would cause the need for equivalent or higher licensing and qualification standards, and that intense lobbying and other political efforts initiated by the insurance industry have prevented this from occurring.

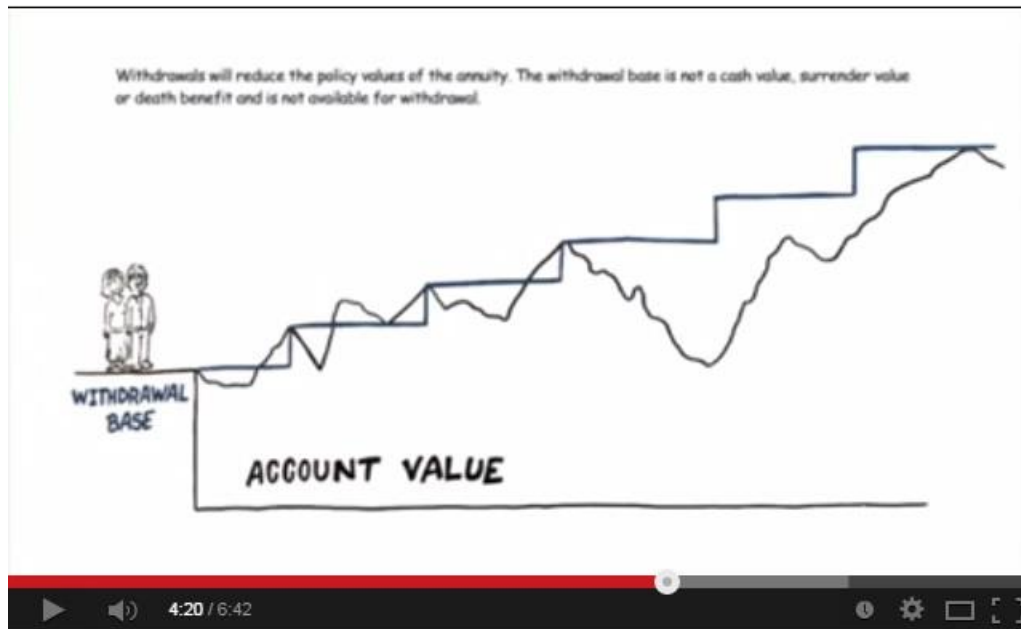
The following picture and description is from a Transamerica YouTube video that is useful to watch, in order to understand how these products are presented to the public. Transamerica has given us permission to use this material. All rights with respect hereto are reserved by Transamerica. One might think there are benevolent financial genies lurking within these contracts, as opposed to actuarially designed financial mechanisms, which are intended to result in a profit to the insurance company by paying out less money than the insurance company receives from policyholders over time.

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<sup>8</sup> The Series 7 exam is a six hour 250 multiple choice exam, requiring at least a 72% score to pass, while the Series 6 exam is 100 multiple choice questions, taken over two hours and fifteen minutes, requiring a 70% score to pass.

**The description that the narrator reads in this video is as follows:**

**Learn More About...Variable Annuities**



“How are variable annuities addressing today’s challenges? With an option feature called a living benefit rider.

Living benefits within variable annuities offer you the added comfort of knowing that even if your account value declines, the variable component of your contract that can rise or fall with your investment options, and your withdrawal base, the amount used to determine your retirement income, will not decline. More importantly, most living benefits provide features that allow your withdrawal base and your retirement income the opportunity to grow not only when your investment options perform well but also when they under perform.” 3:50-4:25

The link to the video is as follows:

[http://www.youtube.com/watch?feature=player\\_detailpage&v=zjNHO7UPWRs#t=262slow](http://www.youtube.com/watch?feature=player_detailpage&v=zjNHO7UPWRs#t=262slow)

Investment advisor, author and lecturer Michael Kitces has pointed out by the below reproduced July 2, 2014 article posted to his Nerd’s Eye View Blog that many contract holders should consider to begin taking withdrawals without delay if they believe that the minimum lifetime payment guarantee is worth having.

## **Why It Rarely Pays To Wait On Taking Withdrawals From A Variable Annuity GLWB Rider – A Case Study**

**By: Michael Kitces, Posted on Wednesday, July 2, 2014**

Variable annuities with "living benefit" riders that provide retirement income guarantees have been increasingly popular over the past 15 years, and especially in the aftermath of the financial crisis of 2008. The basic idea of such Guaranteed Living Withdrawal Benefit (GLWB) riders is relatively straightforward: to allow policyowners to remain invested in the markets with a chance for upside, while still having a guaranteed floor (in the form of a benefit base against which withdrawals can occur) that itself may grow over time (e.g., at 5%/year). Yet this potential for the benefit base and associated guaranteed income payments to increase over time itself raises a challenging question for retirees who own annuities with GLWB riders: is it better to begin withdrawals sooner rather than later, or let the guarantees continue to grow and withdraw later instead?

While it seems that many retirees prefer to do the latter and wait - perhaps in no small part due to the confused belief that their cash value is guaranteed to grow at 5%/year, when in truth it's simply *their benefit base against which withdrawals can be taken* - a deeper analysis reveals that in the end, most retirees with a GLWB rider may do little more than pay a lot in annuity costs to receive a guarantee to *just spend their own original contributions and nothing more*. The challenge lies in the simple fact that because GLWB riders extract any withdrawals against the policyowner's own cash value first, often the time horizon it takes to actually reach the point where the policyowner has worked through their own cash value and into the insurance company's pocket via the guarantee is actually longer than the client's own life expectancy! *In other words, most clients are just receiving their own money back and may literally die before ever seeing a dime of the insurance company's money under a GLWB rider!*

Accordingly, it turns out that for those who do have annuities with GLWB riders, the best course of action may actually be not to wait, and instead to tap the annuity for permitted withdrawals as soon as possible (to the maximum allowed under the contract). If the funds being withdrawn aren't needed, they can be moved on a tax-deferred basis via a 1035 exchange, or rolled over to an(other) IRA (in the case of a qualified annuity); nonetheless, the simple fact remains that, with only a few exceptions, the best way to maximize the value of a GLWB rider is to *not wait* and let it grow at all, as the benefit increases just aren't enough to offset the shortened time window of life expectancy that results from waiting in the first place! Instead, the best course of action is to actually *try* to deplete the annuity as quickly as possible, in an attempt to reach the point where the policyowner can get a "return" from the insurance company (and not just the policyowner's own original funds) to earn a benefit for the annuity expenses that are being paid all along!

### **Reviewing A Client's Annuity With A GLWB Living Benefit Rider**

In working with another advisor, I recently came across the following "case study" scenario, which provided an illustrative case of the unique problems that arise with trying to wait on taking withdrawal benefits from a variable annuity with a Guaranteed Living Withdrawal Benefit (GLWB) rider.

In this case, the client was a single female who had deposited \$100,000 into a variable annuity (from a major insurance carrier) with a GLWB rider five years ago (in April of 2009, near the trough of the market). She was 65 at the time, and as she now approaches age 70, five years later (and five years into a bull market!), is trying to decide what to do next.

The contract value is now up to \$156,586 as of the most recent statement, and is invested in a roughly 60/40 stock/bond portfolio using the company's (required) moderate growth portfolio (which represents a healthy 9.4% average annual rate of return, albeit over a time horizon that the equity markets were up well over 100% cumulatively). Because the contract has been growing at a healthy pace, the annuity's GLWB benefit base also recently stepped up to the same \$156,586 value. Going forward, the benefit base will grow by 5% of the currently-stepped-up amount, with a guarantee that at the 10-year anniversary (which is another 5 years from now), the benefit base will automatically step up to \$200,000 (if it's not already higher and there have been no withdrawals).

If the client chooses to withdraw, she can receive 6% of the benefit base (\$156,586), which would amount to an annual withdrawal of  $6\% \times \$156,586 = \$9,395$ ; this withdrawal of \$9,395/year is guaranteed for life. Under an additional rider, the withdrawal percentage is doubled (to 12%) if the client is confined to a hospital or nursing home.

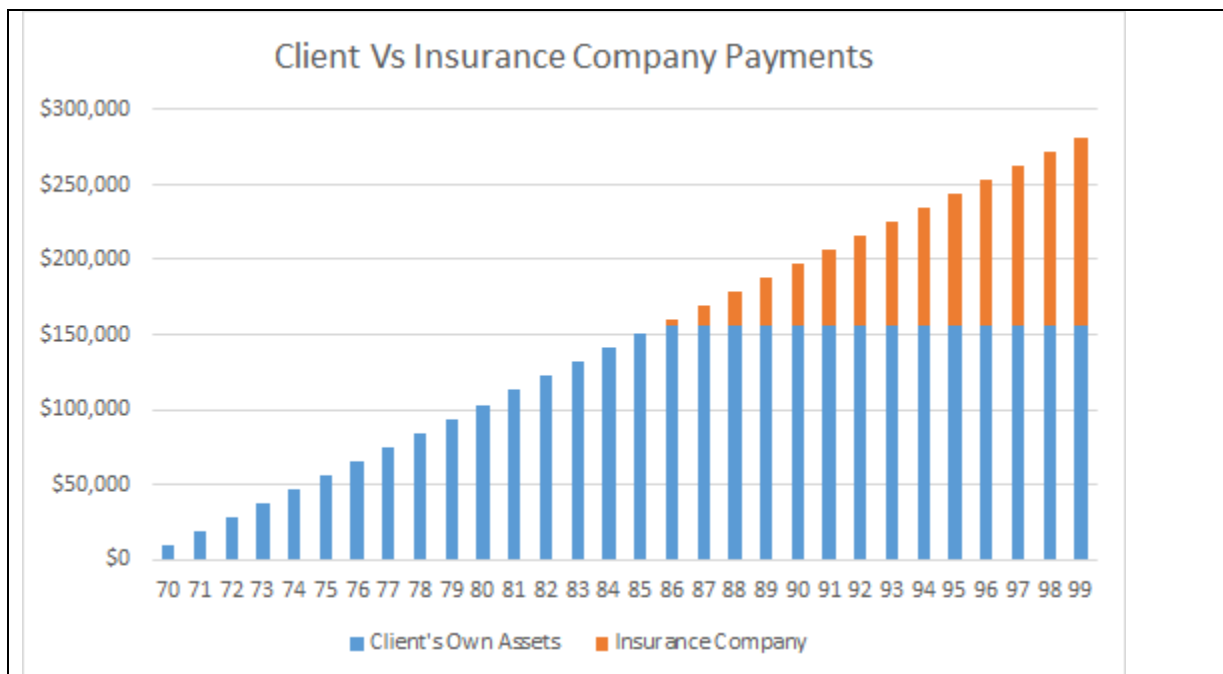
The cost of the annuity was 1.3% of the cash value for the core mortality and expense fees, plus another 0.90% for the GLWB rider (calculated on the benefit base). The rider fee was recently increased to 1.65% going forward when the GLWB benefit base stepped up to the 5-year anniversary value. This brings the total cost of the annuity to 2.95% (given that the benefit base is currently equal to the cash value), and the cost is further increased by another 0.15% for a hospital/nursing home enhancement benefit. **Thus, the total all-in cost for the annuity is 3.10% for its various guarantees.**

The client will also still pay the expense ratios for the underlying investment subaccounts (which range from 0.42% to 1.59% depending on the funds chosen). The currently required moderate growth allocation fund has an average expense ratio of approximately 0.80% (bringing the true total cost to approximately 3.90%).

The client indicated that she originally purchased the contract to protect a portion of her retirement assets after the 2008 financial crisis, when she was nervous about the ongoing market volatility and wanted to be certain there was some guarantee underneath her assets. As the markets have recovered, she has not needed to use her guarantee (or take any withdrawals at all), and has only recently begun to consider taking withdrawals to supplement her retirement income. However, as markets have begun to get more volatile, she is once again considering whether it is worthwhile to continue holding onto the annuity and wait before drawing any income, to let the income guarantees accrue even higher.

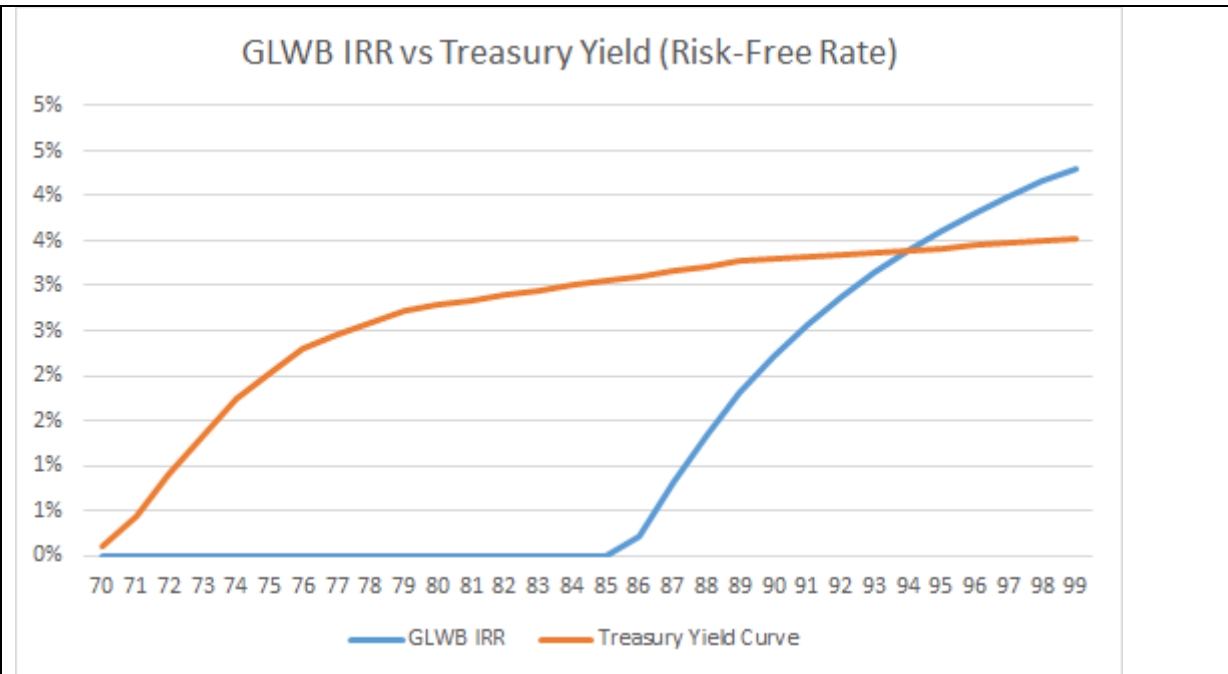
### **Evaluating The Value Of A GLWB Living Benefit Rider Guarantee**

The fundamental caveat of a GLWB rider is that in the initial years, withdrawals are little more than the company returning the client's own cash value. Thus, for instance, while the client can take \$9,395/year from the contract, the client has \$156,586 in the contract already, which means for almost 17 years, the client *will simply be withdrawing their own money as though there was no guarantee*, and it's only in the 17th year and beyond that the insurance company actually begins to pay out. Notably, as shown in the chart below illustrating cumulative payments out of the annuity, *the client will already be age 87 by the time any money actually comes from the insurance company's prospective guarantees!*

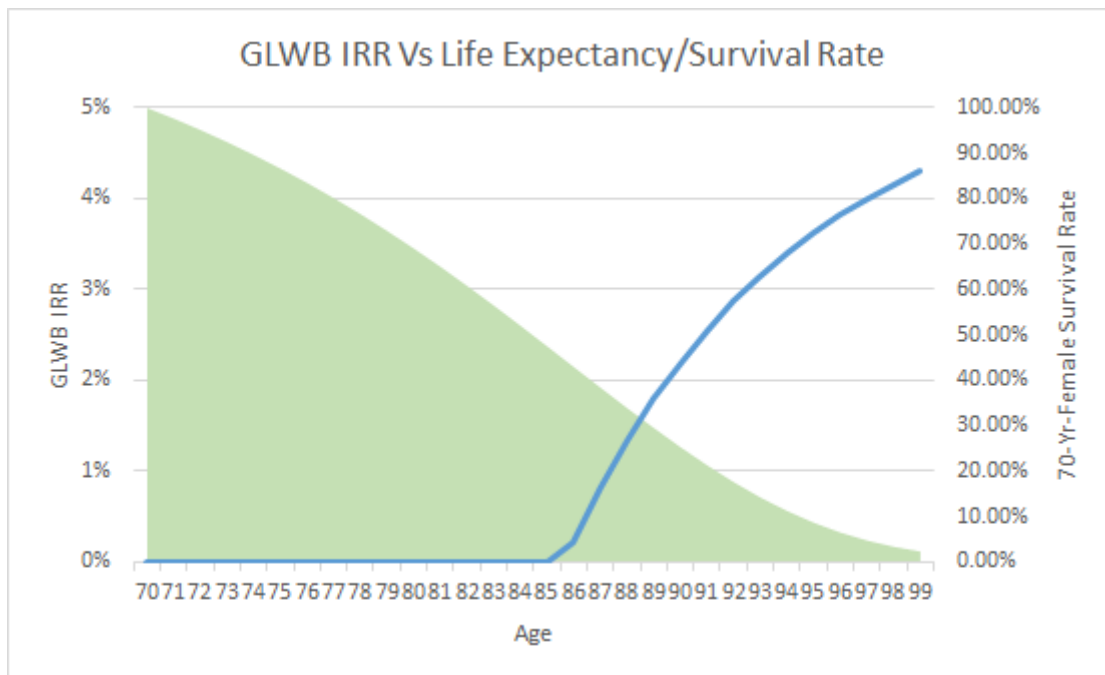


Beyond age 87, the client actually does begin to receive payments from the insurance company – i.e., the actual “benefit” that was being paid for all along the way. However, given that the payments will still only be \$9,395/year, the economic value of the guarantee isn’t much initially. After all, it doesn’t take much of an Internal Rate of Return (IRR) on \$156,586 to get 18 years’ worth of \$9,395/year payments under the guarantee; turning \$156,586 into \$169,110 of cumulative payments is only an internal rate of return of 0.8%! By contrast, just buying a guaranteed Treasury Bond for 18 years in today’s environment is a yield of almost 3%! The chart below shows the payoff for the internal rate of return on the GLWB, versus just buying Treasuries (as of 4/17/2014) over a similar time horizon. From this perspective, the client doesn’t actually reach a point where the IRR on the GLWB is better than the risk-free rate of a comparable time horizon until the client turns 94!





In turn, it's important to put these time horizons in perspective for a 70-year-old female. Life expectancy (based on Social Security mortality tables) at that point is just under 15 years; the odds the client is even alive by age 87 – which is just the point that the insurance company *starts* to pay anything other than the client's own money back to them – is only 38%. It's not until age 94 that the IRR of the GLWB rider exceeds the risk-free rate of a comparable time horizon; but there's only an 11% survival rate for the client to last that long anyway!



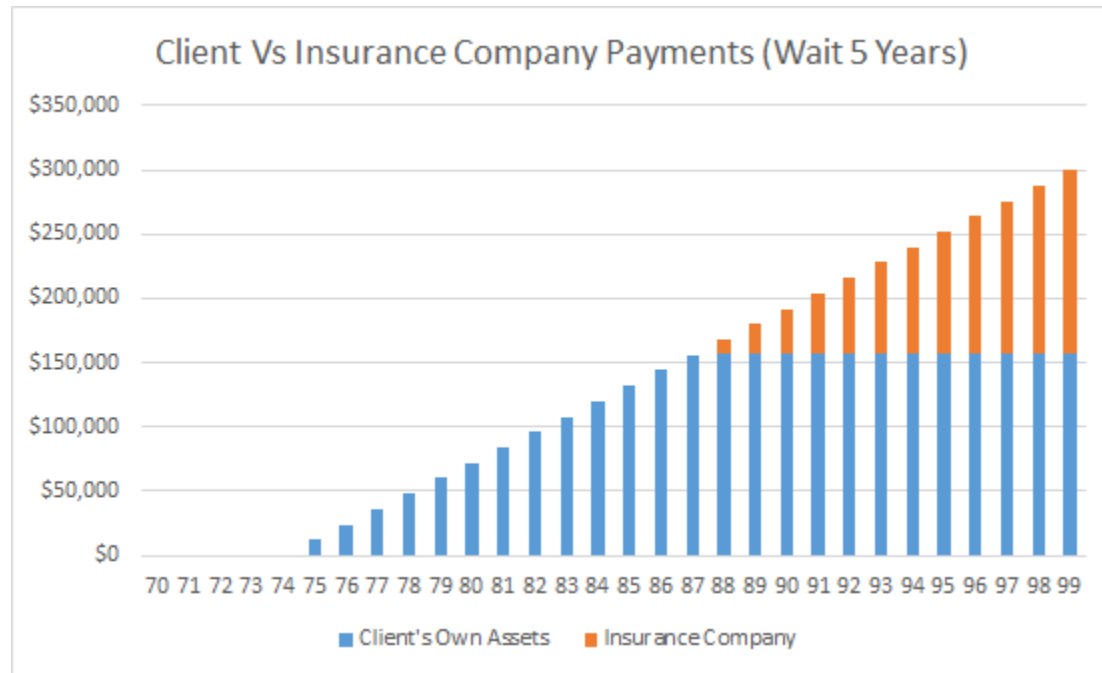
In other words, the odds the client even survives long enough to get payments that exceed the risk-free rate is about 1-in-9, and the odds that the client ever sees *anything* but their own money returned

to them is less than a coin flip! In the majority of cases, all the GLWB rider has actually provided is a guarantee that the client can spend her *own* money which she *already* had, at a cost of 3.10%/year (or about 3.90% including the underlying subaccount expense ratios)! Of course, the guarantee also provides an opportunity for upside... though arguably there's not much potential for upside when the client is obligated to remain in a moderate growth balanced portfolio dragging almost 40% in low-return bonds while being slowed by a 3.90% expense ratio headwind!

### Waiting For A GLWB Benefit Base To Grow

Notwithstanding the somewhat dismal time horizons for the client to reach her breakeven points, there is often still a desire to keep the GLWB rider in place, and allow the benefit base to continue to grow. After all, in an environment where there is concern that market returns could stumble after an amazing 5-year run, the appeal of a “5% guaranteed growth rate” under the GLWB rider is appealing.

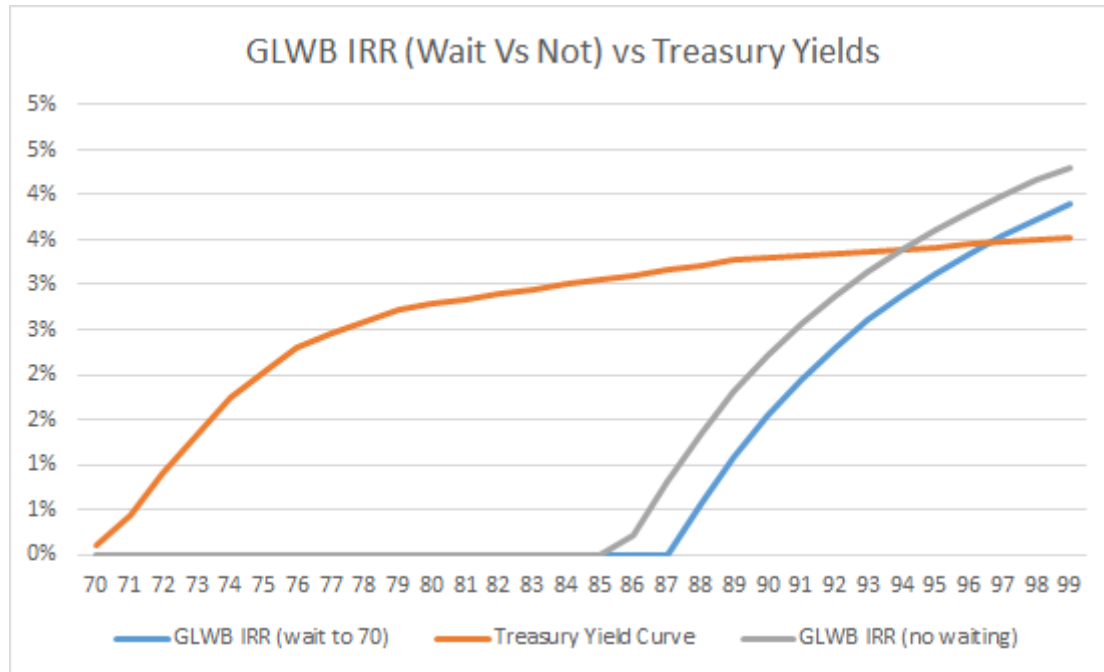
Yet it’s crucial to remember that a *GLWB 5% growth rate is not a guaranteed growth rate on the cash value; it is a growth in the GLWB benefit base upon which future guaranteed withdrawals are calculated.* Accordingly, if we really want to assess the value of waiting another 5 years until the GLWB benefit base can grow to \$200,000, we must reassess the outlook of the prior charts after 5 years, when the guaranteed withdrawals would be \$12,000/year (paying what would then be 6% of a benefit base that's up to \$200,000). For the time being, we’ll assume market returns really are mediocre (or at least, not enough to beat the 3.90% expense ratio), so there is no further growth in the cash value. Accordingly, the profile of payments (client’s own cash value versus insurance company payments) is shown below.



Notably, the outcome of this chart is that while the insurance company provides larger payments in the later years, *now it takes until age 88 to reach the breakeven in the first place* (even if we're still "just" withdrawing against the current \$156,586 of cash value after another 5 years)! In other words, by waiting to let the GLWB base grow, it actually takes slightly *longer* to reach the point where the client ever spends anything besides their own money anyway (remember the client only had to wait until age 87 by starting today, per the earlier chart!). And if the portfolio grows *at all* in the coming

years (so the client withdraws against a higher cash value), the insurance company might not have any obligations until the client turns 90+!

Similarly, the next chart below shows the IRR on the payments over the time horizon (compared to Treasuries, and the results by *not* having waited). As the results show, when accounting for the fact that it takes longer for the payments to reach the crossover point where it's actually the insurance company's money being paid at all, *the IRR after waiting is actually lower than beginning immediately*, and it takes all the way until age 97 before the GLWB guarantee is better than the risk-free rate for a comparable time horizon (and at that point, the odds of survival are less than 5% in the first place!!).



As mentioned earlier, the client's contract also has a rider that doubles the available withdrawal percentage in the event the client is confined to a hospital or nursing home. Yet in this situation as well, it's difficult to justify the benefits of waiting. Even at a doubled percentage, the client would be withdrawing "only" \$24,000/year at the higher benefit base in the future, and it would still take nearly 7 years for the client just to spend through his/her own money – despite the fact that the average stay in a nursing home is closer to "just" 2.8 years!

### Why It Doesn't Pay To Wait For GLWB Riders

Of course, the outcomes shown above were all assuming that the cash value of the contract does not grow further, and that the GLWB guarantees actually have to be relied upon. Yet ironically, that's also the point. If the markets are up a little bit, the fundamental results won't be any different – it may just take even longer for the future GLWB withdrawals to work through the client's own cash value, making the guarantees even less valuable in an up market. And if the markets are up significantly, the GLWB guarantee will be irrelevant altogether, even while its non-trivial 3.90% all-in cost continues to drag down returns significantly (or a 3.1% expense ratio after accounting for a comparable investment fee in a moderate growth fund outside the annuity)! In other words, if the markets are down the client may never live to see the benefits of the GLWB rider, and if the markets are up, the client may never live to see the benefits of the guarantees, either!

Accordingly, what all of this analysis actually implies is that the best thing the client can do with a GLWB rider is to *begin taking withdrawals as early as possible*, and *not* waiting for the GLWB benefit base to grow, for the simple reason that as shown, the value of the guarantee actually is not growing fast enough to offset the shorter time horizon and higher mortality inherent in waiting in the first place. To the extent the money withdrawn under the guarantee isn't actually needed in the first place, it's still desirable to take withdrawals sooner rather than later, *even if it simply means doing a partial 1035 exchange to a new annuity* (to avoid tax consequences), or a partial IRA rollovers (in the case of a qualified annuity). In other words, the client doesn't have to spend the money, or even pay taxes on it; the goal is just to get it *out* of the current annuity contract and try to work down to the point where the GLWB actually pays something beyond just the client's own existing cash value, while the client can reinvest the funds for growth *without the unique 3.1% cost drag of the annuity, or the restricted investment choices*.

Clearly, the caveat to this sample case study is just that – it's a case study, an example, an anecdote, and a sample size of one. Nonetheless, it appears that this dynamic is not unique to the particular client/contract involved here; not only do I see this commonly in practice when reviewing existing annuities with GLWB riders, but retirement annuity and actuarial expert Moshe Milevsky has shown in his research that this approach – to tap GLWB riders sooner rather than later – actually *should* be the standard, and waiting is the unique exception to the rule. In his “Optimal Initiation of a GLWB in a Variable Annuity” study last year, Milevsky and his co-authors found that in general, retirees should be tapping their GLWB annuities as early as their late 50s or early 60s, especially given that many contracts today limit volatility (by requiring asset allocation models), and have ‘modest’ roll-ups. As insurance costs for such riders rise (as they have in recent years), and especially if interest rates (i.e., the risk-free rate on Treasuries rises), it only becomes even more desirable to begin withdrawals earlier rather than later!

As many intuitively note, there is a concern to tapping an annuity with a GLWB rider sooner rather than later – it increases the risk that the contract will be depleted. Yet as Milevsky points out in his research – and the point of this article as well – *that's actually the goal!* Until the contract runs out, the client is simply paying annuity guarantee fees to spend their own money. The goal is to get to the insurance company's money, which means tapping the annuity as soon as possible. As noted earlier, if the funds aren't needed, they can simply be withdrawn, 1035 exchanged, or rolled over, to minimize the tax consequences; the money doesn't have to be *spent*, it just has to *leave the annuity*. The end result and goal is to salvage most/all of the money (invested without that 3.10% expense drag!), *and* deplete the original annuity to the point that the insurance company pays its benefit, too.

Notwithstanding this research, it is of course still important to analyze the details of any particular annuity contract (or get assistance from a firm that has the expertise to support advisors in this analysis), as no two annuity riders work exactly the same, and there may well be some exceptions to this general rule. In addition, it's still important to be certain not to withdraw *more* than the amount permitted to be taken on a dollar-for-dollar basis under the GLWB rider, and surrender charges (if applicable) must be navigated as well (although withdrawals under GLWB riders are generally modest enough to avoid surrender penalties). In addition, many GLWBs will now vary the permitted withdrawal percentage based on certain age bands (e.g., 4% for those under age 60, 5% for those under age 70, 6% for those under age 80, and 7% for those beyond age 80), and clients close to an age band may wish to at least wait until crossing over; thus, for instance, a 69 year old client might not want to withdraw immediately, but instead wait until age 70 and then immediately after his/her begin to withdraw the maximum under the rider. On the other hand, it's also notable that clients with older annuity contracts (especially pre-2005 that had broader dollar-for-dollar withdrawal provisions) may have additional GLWB strategies available to them.

Nonetheless, the fact remains that for those who did buy annuities with GLWB riders, especially in the past 5 years (where due to the bull market, the cash value is likely to be close to the GLWB's benefit base), it often does not pay to wait on a GLWB rider to accrue a higher benefit, both because the benefit isn't rising fast enough to offset the shorter time horizon, and because in the meantime the upside of the contract itself is severely limited given the common expense ratios of today's GLWB annuities. The situation is further exacerbated by the asset allocation limitations of many of today's contracts, which essentially force the investor to hold "only" 60% in equities and other risk assets, despite paying annuity expenses for the guarantees on 100% of the portfolio (which is an indirect form of additional annuity cost). Or viewed another way, it may be appealing to purchase a variable annuity for upside growth plus downside protection, but it's not clear there will be any upside growth in a portfolio within a variable annuity with a GLWB rider dragging 3.1% in annuity costs (plus subaccount expense ratios), in a portfolio that must hold a 40% bond allocation in today's low return environment. Simply put, the "just" 60% in equities can't possibly generate a high enough return to overcome the bond drag, and the annuity cost drag, and still have more upside than just investing conservatively and taking withdrawals in the first place.

Thus, the bottom line is simply this: For those who *do* need the funds anyway (or could use the withdrawals to pair with other strategies like delaying Social Security benefits), tapping a GLWB rider sooner rather than later provides an appealing opportunity to begin to coordinate retirement income strategies. And even for those who *do not* need the cash flows, it *still* pays to get the money out of the GLWB rider to the maximum allowable under the terms of the contract, even if it just means the money is moved as tax-efficiently as possible to another investment alternative instead!

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Michael E. Kitces, MSFS, MTAX, CFP, CLU, ChFC, RHU, REBC, CASL  
Pinnacle Advisory Group, Inc.  
6345 Woodside Court, Suite 100  
Columbia, Maryland 21046  
Tel. (410) 995-6630 michael@kitces.com Fax. (410) 505-0960

### **Concerns with Respect to Sales of Variable Annuities to Senior Citizens**

Annuities have high maintenance expenses to compensate for their safety and structure. These high fees, which can be from 3.5% to 4% or more per year, plus annuity premium taxes, add up to large expenses and detract significantly from the value of the investment. Additionally, investors find that these investments require specific and less flexible payout provisions. Variable annuities are known for having excessive surrender fees. Although a few companies offer variable annuity products with low-cost subaccounts, the majority of annuity products have such high maintenance fees that they are not worth the sacrifice in liquidity for older investors<sup>9</sup>. Even where management fees are minimized by use of a passively managed index fund, many financial planners believe that variable annuities may not be worth the trouble considering that there is a multitude of cheaper alternatives allowing for liquidity.

These high fees, lengthy surrender periods, and high early-withdrawal penalties make an annuity a less attractive choice for a senior investor needing liquidity for unexpected health care costs. Unfortunately, reports show that many agents do not inform senior investors of these downfalls. Equity-indexed fixed annuities are famous for high and long surrender charges. Most variable annuities have either zero, four or seven year surrender charge periods with a surrender fee

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<sup>9</sup> Mel Lindauer, *Annuities: Good Bad Or Ugly?*, <http://www.forbes.com/2010/06/04/variable-annuities-high-cost-surrender-fees-personal-finance-bogleheads-view-lindauer.html> (June 04, 2010).

starting at around 7%, if any, and often declining over time. However, this charge is commonly waived in the case of certain life events, such as going to a nursing home, terminal illness, death or disability.

In 2007, the National Association of Securities Dealers (“NASD”) (now named Financial Industry Regulatory Authority or “FINRA”), the Securities Exchange Commission (“SEC”) and the North American Securities Administrators Association (“NASAA”), released an Investor Fraud study. These organizations took initiative to help prevent elder financial abuse by conducting a series of investigations. Most notably, they investigated financial fraud occurring at “free lunch” seminars. These seminars, targeted at seniors, promise to educate invitees regarding investment strategies at no cost and frequently offer a complimentary meal or prizes. However, often attendees do not know that the companies sponsoring these events are in the business of selling the products promoted.

This report discusses methods that were frequently used in the sale of annuities at these “educational seminars.” Financial companies, targeting individuals age 65 and older, send invitations for educational seminars using mass mailings with deceptive content such as “startling presentation reveals costly mistakes that can ruin your finances” or “there is a financial storm brewing.”<sup>10</sup> Seniors attending these “free lunch” seminars receive misleading financial planning advice through use of paid testimonials and comparisons of dissimilar investments. Next, sales agents, using personal information acquired from the seminars, contact attendees individually. Agents claim to let customers in on “inside” industry information in an attempt to gain the customer’s trust. The agent will review the senior’s current investments and any annuity contracts and strongly suggest that he or she immediately consider trading current policies for “more beneficial” products, available only for a “limited time.” Should the customer have any concerns regarding the liquidity of the money invested, the agent may reassure the customer that he will be able to withdraw money from the policy for emergency health care and long-term care needs and will conveniently fail to mention the high surrender charges that are applicable to the previous policy or falsely advise the customer that the cost of the surrender charge will be covered during the first few years of the new policy.<sup>11</sup>

In a nation with a growing population of seniors reaching retirement age, elder financial abuse has become an issue of developing concern. According to the Census Bureau’s report, by 2030 19.6% of the American population will be 65 or older.<sup>12</sup> Due to advancements in health care, individuals are living longer, meaning that their assets and retirement plans must last longer as well.

In light of these reports of elder financial abuse, the following question must be raised: is the source of the problem a lack of consumer education or a lack of regulatory protection? Contrary to common belief, the Investor Fraud Study showed that senior purchasers buying these financial products, such as variable annuities, have received a higher education and have above average financial knowledge.<sup>13</sup> Therefore, we must turn to the adequacy of the current regulations governing the sale of financial products.<sup>14</sup>

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10 Office of Compliance Inspection and Examinations, Securities and Exchange Commission, North American Securities Administrators Association and the Financial Industry Regulatory Authority, Protecting Senior Investors: Report of Examinations of Securities Firms Providing “Free Lunch” Sales Seminars, (September 2007).

11 Teresa K. Bowman, “Inappropriate Sale of Annuities and the Impact on Long Term Care Planning,” <http://boyerjackson.com/the-cost-of-long-term-care/inappropriate-sale-of-annuities-and-the-impact-on-long-term-care-planning/>

12 U.S. Census Bureau, Current Population Reports: 65+ in the United States: 2005 195, [www.census.gov/prod/2006pubs/p23-209.pdf](http://www.census.gov/prod/2006pubs/p23-209.pdf) (December 2005).

13 NASD Investor Education Foundation, Investor Fraud Study Final Report 5-6 (May 12, 2006).

14 FINRA Regulatory Notice 07-43, FINRA Reminds Firms of Their Obligations Relating to Senior Investors and Highlights Industry Practices to Serve these Customers, (September 2007).

## **Federal Regulations**

The SEC and FINRA have also taken action. In 2007, FINRA, recognizing the aging of the Baby Boomer Generation and the increase in abusive sale tactics, drafted a regulatory notice aimed at senior investors, reminding firms of their ethical obligations in the sale of securities and financial products.

The purpose of these self-regulatory measures is to ensure adequate education and ethical compliance by agents. Although FINRA does not have special rules for senior consumers, the rules attempt to protect all buyers from surreptitious sale tactics. FINRA Rule 2111 requires that when recommending an investment strategy, an agent must have a “reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the member or associated person to ascertain the customer’s investment profile<sup>15</sup>.” In other words, an agent must consider “the customer’s age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the customer may disclose.”<sup>16</sup> Further, “a senior’s fixed income, risk tolerance, tax status, and need for liquidity must be considered.”<sup>17</sup>

FINRA strongly suggests that sellers of financial products ask senior customers questions such as: (1) Is the customer retired, and if so, is the customer living on a fixed income?; (2) How much income is needed for current and future expenses, considering the existence of mortgages?; (3) Does the customer have health care insurance?; and (4) will the customer be relying on investment assets for unanticipated health care costs?<sup>18</sup>

The SEC and FINRA are also concerned about the use of self-proclaimed, designations, such as “senior specialist” or “certified senior advisor,” which may falsely indicate expertise and potentially violate FINRA Rules 2110 and 2210. As such, some firms have banned these types of titles in an attempt to eliminate confusion or misrepresentation. In an effort to minimize the use of such deceptive titles, FINRA has provided a list of appropriate designations with their respective qualifications.<sup>19</sup>

## **Recent Florida Regulations**

The state of Florida is an easy target for unscrupulous agents who prey on unsuspecting senior investors. In 2008, the Florida Department of Financial Services reported that consumer protection complaints regarding financial planning products had almost doubled from the previous year.<sup>20</sup> Further, a 2009 study showed that out of 472 elder financial abuse investigations, 70% concerned annuity and life insurance sales.<sup>21</sup> As the Baby Boomer Generation ages, the frequency of elder financial abuse is expected to grow.

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15 FINRA Rule 2111(a)

16 Id.

17 Id.

18 See Id. at 2 (provides a complete list of suggested questions).

19 This list may be found at: <http://apps.finra.org/DataDirectory/1/prodesignations.aspx>. It is important to note that FINRA does not endorse the respective designations, and merely provides the list as an effort to encourage compliance. For example, in order to use titles such as “Certified Financial Gerontologist” or “Certified Specialist in Retirement Planning,” the agent must complete training and continuing education requirements.

20 Alex Sink, Address, Updates to Florida’s Senate’s Insurance and Banking Committee, (Tallahassee, Fla., Mar. 18, 2008) (copy at <http://www.flds.com/>).

21 Alex Sink, Press Conference, (Tallahassee, Fla. Feb. 17, 2009) (copy at <http://www.myfloridafco.com>).

In 2008, Florida enacted the “John and Patricia Seibel Act,”<sup>22</sup> named after a Venice, Florida couple in their 80’s who were sold \$600,000 in annuities with surrender periods of up to 15 years. This Act provided that an investor who was 65 years or older would have an unconditional right to a full refund within 10 days of signing an annuity contract. Additionally, this Act outlawed the practices of “twisting” and “churning.” According to Black’s Law Dictionary, “twisting” is the practice of an insurance agent or company “misrepresenting or misstating facts, or giving an incomplete comparison of policies to induce an insured to give up a policy in one company and buy another company’s policy.”<sup>23</sup> The law also required that agents have a reasonable basis for believing the recommendation is appropriate. This objective standard required agents to take all factors, such as age and health of the investor, into consideration before making a sale.

The Safeguard Our Seniors Act came into effect in 2011 and increased the penalty for the willful act of twisting or churning of an annuity to a maximum of \$75,000. It limited the surrender charge to 10% and the period to 10 years. Further, it extended the “free look” period for a senior purchaser from 14 to 21 days and required an insurer to provide a cover sheet attached to the policy regarding the free look period.

Florida more recently passed a new Act that took effect October 1, 2013, and will extend the protection from the Safeguard Our Seniors Act to Florida residents of all ages.

Most states have guarantee funds that pay an investor who lost monies by reason of a carrier failure, but many of these do not cover variable annuity products. Variable annuities that held hedge fund investments that contained Madoff investments lost significant value without any ability to obtain Securities Investor Protection Corporation (“SIPC”) coverage. SIPC is a federally required not-for-profit member funded company that protects investors from financial harm if a broker-dealer fails.<sup>24</sup>

For example, the Florida guarantee fund will guarantee up to \$250,000 per contract and up to three contracts per carrier for annuities issued to Florida residents. Florida Statute 631.717 reads as follows:

The association’s liability for the contractual obligations of the insolvent insurer shall be as great as, but no greater than, the contractual obligations of the insurer in the absence of such insolvency, unless such obligations are reduced as permitted by subsection (4), but the aggregate liability of the association shall not exceed \$100,000 in net cash surrender and net cash withdrawal values for life insurance, \$250,000 in net cash surrender and net cash withdrawal values for deferred annuity contracts [AUTHORS’ NOTE: VARIABLE ANNUITY CONTRACTS ARE ONLY COVERED TO THE EXTENT GUARANTEED BY AN INSURER], or \$300,000 for all benefits including cash values, with respect to any one life. In no event shall the association be liable for any penalties or interest.

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22 § 627.4554 Fla. Stat. (2013).

23 Black’s Law Dictionary (Bryan A. Garner., 9th ed., West 2009).

24 See “Are You Protected If Your Insurance Company Goes Belly-Up? John J. Pitloch, CFP®, MST, CPWA®, CIMA® at <http://www.investopedia.com/articles/insurance/09/insurance-company-guarantee-fund.asp>



### **Private Placement or Offshore Arrangements**

For private placement or offshore arrangements, special account structuring can be used to ensure that financial institutions holding the assets for the carrier will not permit the carrier to draw from the assets without consent from an appointed independent professional advisor. This prevents theft by the carrier. It is of course very important to work with a reputable carrier that has sound tax and legal opinions from United States-based law firms who do comparable work for United States-based nationally known carriers.

Private placement annuity planning may allow the client or family members to sell appreciated assets to the variable annuity contract, or other entity that it might own, in exchange for installment notes or annuity payments to defer gain on the asset. This allows future appreciation of the sold assets to escape income tax in the case of a life insurance policy, or to be sold on a tax-deferred basis if held under an annuity policy. For example, an individual owning stock with an income tax basis of \$10,000 and a fair market value of \$100,000 might sell that stock to a life insurance policy in exchange for a \$100,000 annuity payable \$10,000 a year for 11 years. The income tax on the \$90,000 of gain would be deferred by being recognized over 10 years. If the life insurance policy later sells the stock for \$1,000,000, it would pay no income tax. If the insured dies while the policy is intact, then all of the policy proceeds will go to the beneficiaries tax free.

### **Insurance Carrier Registration and Requirements**

Companies that issue annuities in the United States are required to be registered in each state where annuities are issued and to follow applicable disclosure and benefit laws.

Insurance carriers registered only outside of the United States are subject to varying degrees of supervision and regulation. For example, a Cayman Islands, Bermuda, or Bahamas insurance carrier can invest annuity monies into private companies, individual stocks, or even real estate, subject to diversification rules that apply if the contract is to qualify as an annuity under the Internal Revenue Code. If the diversification rules of Treasury Regulation 1.817-5 are not met, then all income under the variable annuity contract will be treated as ordinary income.

### **Annual Costs and Surrender Charges**

Of the hundreds of state-registered annuity companies that sell investments, only a few of them offer “no load commission-free” products. The annual costs associated with these no-load variable annuities are much lower than with most carriers. There are typically exceptions to surrender charges, such as if the policyholder dies or if a withdrawal does not exceed 10% of the value of the contract each year.

In most states, sales representatives are not required to specifically disclose commissions or internal costs to purchasers, but are required to deliver prospectuses that contain the costs and charges. However, the prospectuses are rarely read. While many sales representatives disclose commissions or internal costs to prospective purchasers, purchasers might not fully understand this information and how it can affect the anticipated return on the applicable investment. Commissions are designed to compensate sales representatives for their sales efforts and for the financial advice that they render to prospective customers. Nevertheless, it is important to make sure that clients fully understand these commissions and costs before they become legally bound to purchase an annuity contract. In most states, the contract must be physically delivered to the customer and the customer has a certain period of time after receiving the contract to terminate it and receive their investment back.

**An Example of the Financial Cost of Annuitization**

A 59 year old client, who invested \$100,000 in a variable annuity with a “guaranteed value feature”, wanted to convert his \$159,700 “guaranteed value” into an annuitized contract, because that is the only way under the contract to make use of the guaranteed value. The carrier indicated that this would entitle him to a \$9,078.24 per year payment for life or 10 years, whichever is longer.

His standard table life expectancy was 22.3 years, so he was expected to live until age 81. In reality his health is problematic, and he expects to die before age 81. Assuming that he would reach age 81, the rate of return on this investment would be 2.36%, based on the following chart:

<b>Age</b>	<b>Last Year</b>	<b>Investment</b>	<b>Annual Payment</b>	<b>Cumulative Payments</b>	<b>Rate of Return</b>
59	1	\$159,700.00	\$9,078.24	\$9,078.24	-94.31%
60	2		\$9,078.24	\$18,156.48	-73.15%
61	3		\$9,078.24	\$27,234.72	54.45%
62	4		\$9,078.24	\$36,312.96	-40.89%
63	5		\$9,078.24	\$45,391.20	-31.20%
64	6		\$9,078.24	\$54,469.44	-24.14%
65	7		\$9,078.24	\$63,547.68	-18.86%
66	8		\$9,078.24	\$72,625.92	-14.81%
67	9		\$9,078.24	\$81,704.16	-11.65%
68	10		\$9,078.24	\$90,782.40	-9.14%
69	11		\$9,078.24	\$99,860.64	-7.11%
70	12		\$9,078.24	\$108,938.88	-5.44%
71	13		\$9,078.24	\$118,017.12	-4.06%
72	14		\$9,078.24	\$127,095.36	-2.91%
73	15		\$9,078.24	\$136,173.60	-1.93%
74	16		\$9,078.24	\$145,251.84	-1.09%
75	17		\$9,078.24	\$154,330.08	-0.38%

<b>Age</b>	<b>Last Year</b>	<b>Investment</b>	<b>Annual Payment</b>	<b>Cumulative Payments</b>	<b>Rate of Return</b>
76	18		\$9,078.24	\$163,408.32	0.24%
77	19		\$9,078.24	\$172,486.56	0.78%
78	20		\$9,078.24	\$181,564.80	1.25%
79	21		\$9,078.24	\$190,643.04	1.67%
80	22		\$9,078.24	\$199,721.28	2.04%
81	23		\$9,078.24	\$208,799.52	2.36%
82	24		\$9,078.24	\$217,877.76	2.65%
83	25		\$9,078.24	\$226,956.00	2.91%
84	26		\$9,078.24	\$236,034.24	3.14%
85	27		\$9,078.24	\$245,112.48	3.35%
86	28		\$9,078.24	\$254,190.72	3.54%
87	29		\$9,078.24	\$263,268.96	3.71%
88	30		\$9,078.24	\$272,347.20	3.86%
89	31		\$9,078.24	\$281,425.44	4.00%
90	32		\$9,078.24	\$290,503.68	4.13%
91	33		\$9,078.24	\$299,581.92	4.24%
92	34		\$9,078.24	\$308,660.16	4.35%
93	35		\$9,078.24	\$317,738.40	4.44%
94	36		\$9,078.24	\$326,816.64	4.53%
95	37		\$9,078.24	\$335,894.88	4.61%
96	38		\$9,078.24	\$344,973.12	4.69%
97	39		\$9,078.24	\$354,051.36	4.76%

Age	Last Year	Investment	Annual Payment	Cumulative Payments	Rate of Return
98	40		\$9,078.24	\$363,129.60	4.82%

The client was very disappointed, because he thought that the financial guarantees in the policy would allow him to withdraw \$159,700. As it turned out, it only allowed for this amount to be annuitized, with the above result. He paid annual costs of approximately 3.5% a year for this annuity and ended up exchanging it for a less expensive product after the surrender charge decreased to 2%. He switched to an annuity policy that charges approximately 0.7% per year, so it was worthwhile to pay a 2% surrender charge to change policies.

### **A Time and a Place for Variable Annuities**

Under the right circumstances variable annuities may be an appropriate investment for some individuals or families, although the majority of financial planners believe that they are usually not appropriate. A variable annuity contract is an agreement to have a life insurance or annuity company hold mutual funds or similar investment portfolios under the annuity “wrapper”, or to provide rates of return calculated by reference to the performance of one or more financial indexes, like the Standard & Poor 500, NASDAQ Composite or Dow Jones Index. As St. Petersburg, Florida financial planner, Gene Stern, put it, “[variable annuities provide] protected income for a portion of a client’s needs.”

Mr. Stern provided the following example:

“A financial plan for a couple, each age 65, \$2 million net worth and no debt, and both will qualify for the maximum Social Security benefit. In doing my plan, I did not recommend that they consider the purchase of an annuity as they did not need protected income to meet their ‘needs expense.’ I did suggest the purchase of a particular annuity product to protect assets from long-term care needs on a joint basis. When all was said and done, the husband (an engineer) asked me why I did not propose a fixed index annuity. I asked him why he thought he needed it and he said: ‘I have to take a required minimum distribution from my 401(k) of \$550,000 and I would like to have the highest possible income from those assets without having to worry about the market tanking.’ Withdrawal draw down rates are now being recommended to be 3.5%, and I was able to use that 401(k) to create an average of 5.5% drawdown factor of an increasing value for the first few years. With a contract from a carrier I chose, even when the account value fell to zero, it will still have a potentially increasing income due to the fact the index does not go away and this was on a joint life basis. This \$550,000 was able to generate the same income that an invested account needed to be worth \$748,000 at a 3.5% drawdown.”

## **CHAPTER 7**

### **SPECIAL TAX AND ESTATE PLANNING CONSIDERATIONS OF ANNUITIES**

As discussed in Chapters 2 and 3, annuities provide the ability to defer the recognition of taxable income until monies are received from the contract, but they turn capital gains into ordinary income.

If a qualified plan or IRA can invest directly in mutual funds, then it is saving the cost and expenses associated with the annuity from its investment return. In many cases, clients will be better off holding a tax-efficient mutual fund that yields a small amount of ordinary income each year, a small amount of capital gains, and capital gains if and when the fund is sold before the client dies. The remaining fund owned by the client on death would receive a date of death fair market value income tax basis under Section 1014.

Clients who invest significant amounts in mutual funds should be advised to understand the income tax characteristics and differences between actively invested mutual funds and less actively invested mutual funds, because the income tax imposed can vary significantly. The authors are including charts in this book which illustrate various financial features of certain annuity products. A sample cover letter explaining these charts is referred to below.

Nevertheless, high tax bracket taxpayers who expect to be in a much lower income tax bracket in the future may consider investing in variable annuities, particularly when the annuities will hold investments that yield significant amounts of ordinary income, such as hedge funds that have significant ordinary income and/or short-term capital gain.

#### **Annuity Death Benefits**

The death benefit provisions found within an annuity prospectus will provide the specific details related to the qualification, timing, and forms of payment of a death benefit and other information with respect to a particular contract. The death benefit of an annuity normally occurs upon the death of either the annuity owner or a separate annuitant, and provides a return of either the account value of the annuity or some other form of minimum payment.

Section 72(s) provides the general rules that a contract must satisfy in order to be treated as an annuity contract for income tax purposes (and therefore be afforded tax deferral advantages). If a contract does not satisfy these rules, then all payments received under the contract after the holder's<sup>25</sup> death will be included in gross income.

In order to use an exclusion ratio to exclude a portion of each payment received from gross income, an annuity contract must provide both of the following:

1. If the holder of the contract dies on or after the annuity starting date and before the entire interest in the contract has been distributed, then the remaining portion of such interest must

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<sup>25</sup> The term "holder" is not defined for the purposes of the death benefit rules under § 72(s). For contracts owned by an individual, the legislative history of § 72(s) indicates that the "holder" of a contract is the party "who controls the beneficial enjoyment of the cash surrender value and enjoys the deferral of tax on income that, except for special tax treatment for annuities, would otherwise be taxable to the holder." This appears to indicate that the owner of the contract is the "holder" before the annuity start date, and that an annuitant who is entitled to payments after the annuity start date is the "holder" after the annuity start date has occurred. However, there is no concrete authority on this issue.

be distributed at least as rapidly as under the method of distributions being used as of the date of the holder's death (the "at least as rapidly" rule); and

2. If any holder of the contract dies before the annuity starting date, the entire interest in such contract must be distributed within 5 years after the death of such holder (the "5-year rule").

If the above two requirements are not satisfied then all monies paid from an annuity will constitute income to the extent that the value of the annuity contract exceeds the investment in the contract.

However, there are several broad exceptions to the above general rules. If one of the following exceptions applies, then the exclusion ratio will apply to defer the income taxes applicable to the amounts received from the annuity contract after the holder's death. These exceptions are as follows:

1. If (a) the annuity contract allows any portion of the holder's interest in the contract to be payable to (or for the benefit of) a "designated beneficiary"; (b) such portion will be distributed over the life expectancy of such designated beneficiary; and (c) such distributions begin no later than 1 year following the holder's death, then such portion shall be treated as distributed on the day on which such distribution begins. This exception is often referred to as the "Life Expectancy Rule."

The term "designated beneficiary" means any individual designated by the holder of the contract. It is not clear whether annuity contracts that are made payable to trusts can be paid over the lifetime of one or more trust beneficiaries in a manner similar to the applicable rules for qualified plans and IRAs. The IRS has not specifically ruled on this issue, and has not issued regulations on this, as it has in the qualified plan and IRA context.

The language of Section 72(s)(2)(A) and Section 401(a)(9)(B)(iii)(I) are almost identical, and both Sections include the language "payable to (or for the benefit of) a designated beneficiary." The authors have nevertheless concluded that an annuity contract cannot qualify for tax deferral under the Life Expectancy Rule if payable to a trust as opposed to being payable to an individual. The authors do not believe that the words "or for the benefit of" or the fact that Section 401(a)(9)(B) is virtually identical to Section 72(s)" are sufficient to merit the opposite result.

2. If the holder's surviving spouse is the designated beneficiary, then the surviving spouse is treated as the holder of the contract, which will allow for the continued deferral of income taxes as if the holder had been receiving the scheduled payments under the contract.
3. If the annuity contract held under a qualified plan described in Sections 401(a), 403(a) or 403(b), is an IRA or held under an IRA, or is a qualified funding asset that is defined in Section 130(d), then the "at least as rapidly" and the "5-year rule" described above do not apply and the income taxation of the contract is controlled by the rules applicable to qualified plans or qualified funding assets.

Where one spouse owns an annuity holding significant built-up income, it will be most prudent to have the owner's spouse be the beneficiary, with the credit shelter trust of the first dying spouse (or the first dying spouse's desired non-spouse beneficiaries, outright and free of trust, if the concern is that the annuity contract payable to a trust is not entitled to tax deferral). The surviving spouse would have nine months after the death of the first spouse to decide whether to accept the

annuity, to treat as an annuity owned from inception by the surviving spouse on a tax-deferred basis, or to disclaim the right to inherit the annuity, so that the alternate beneficiary would hold the economic rights to the annuity.

Planners should be mindful that a surviving spouse who disclaims assets or annuity rights into a credit shelter trust cannot retain any power to direct how the trust assets would pass upon his subsequent death. Further, income laden assets (especially assets carrying income in respect of a decedent) are less effective for purposes of funding a credit shelter trust. If the first dying spouse's credit shelter trust exceeds the amount that passes estate tax free, then the trust documents will typically direct excess assets to a qualified terminable interest trust (a QTIP), which must pay income to the surviving spouse in order to qualify for the estate tax marital deduction. Annuity holders who are married and want to make full use of a credit shelter trust, but also want to assure that benefits will pass eventually to children of a prior marriage, may prefer that annuities be paid to QTIP trusts, notwithstanding the uncertainty and payout issues described above.

Below is a table showing the specific features of the Minimum Death Benefit provided by Carrier 1, Carrier 2, and Carrier 3 that are prevalent among most variable annuities.

	<b>Carrier 1</b>	<b>Carrier 2</b>	<b>Carrier 3</b>
How much will the beneficiary receive?	The Minimum Death Benefit will be the greater of: (1) The sum of all of the Purchase Payments since the issue date until the date of Due Proof of Death, reduced proportionally by the ratio of the amount of any withdrawal to the Account Value prior to the withdrawal; or (2) The Unadjusted Account Value as of the date of Due Proof of Death is received by Carrier 1.	The Death Benefit will be the Accumulated Value of the Variable Annuity Contract on the date the Due Proof of Death and other required company documents are completed and received by Carrier 2.	The amount of the Death Benefit will depend on what date the annuitant dies. (1) If prior to the contract's maturity date, the death benefit will equal the contract value. (2) If after the contract's maturity date, or anytime after payments begin, no Death Benefit is payable. (3) Prior to the contract's maturity date and before the 75th birthday, the Death Benefit will be the greater of: (i) the Contract Value, or (ii) the amount of Purchase Payments minus adjustments for every withdrawal taken.
Exceptions and special requirements for Minimum Death Benefit	(1) If Due Proof of Death is received more than one year following date of death, Carrier 1 has the right to limit the amount of the Death Benefit to whatever value	Carrier 2 will pay a lump-sum Death Benefit within seven days following the election to take the lump-sum payment unless it is delayed beyond seven days by: (1) the New York Stock Exchange being closed on a day other than a weekend or holiday, or trading on the Exchange being	No Detail.

	<b>Carrier 1</b>	<b>Carrier 2</b>	<b>Carrier 3</b>
	<p>remains in the annuity account on the date they receive the Due Proof of Death.</p> <p>(2) If the individual whose death triggers the Minimum Death Benefit was not the owner or annuitant as of the issue date of the contract, the Death Benefit will be suspended for a two year period, starting on the date that individual becomes the owner or annuitant. During this period the Death Benefit is limited to the Unadjusted Account Value upon the date Due Proof of Death is received.</p>	<p>restricted;</p> <p>(2) An emergency exists defined by the SEC, or the SEC otherwise restricts trading;</p> <p>(3) The SEC permits delay for protection of the contract owner;</p> <p>or (4) Payment is derived by premiums paid by check, which may delay payment until the check has cleared.</p> <p>None of the exceptions or special requirements that appeared in the Carrier 1 prospectus were seen in the Carrier 2 information.</p>	
Survival Spouse Continuation	<p>Unless another beneficiary is designated by the Contract Owner, then if there is a surviving spouse, that spouse may continue ownership of the Annuity rather than taking the Death Benefit.</p>	<p>If the spouse is the beneficiary at the date of the contract owner's death, the spouse can take over the annuity contract as if it was his or her own.</p>	<p>The Carrier 3 prospectus makes no reference specifically to a survival spouse continuation of the annuity.</p>
Miscellaneous Provisions	<p>There are other provisions and requirements related to Death Benefits on a variable annuity held by a Tax-favored Plan that</p>	<p>There were additional details in relation to payments to non-natural persons and non-natural persons as contract owners that appeared in the prospectus material, but it went beyond the detail required here.</p> <p>The Death Benefit terminates</p>	<p>No Detail.</p>



	<b>Carrier 1</b>	<b>Carrier 2</b>	<b>Carrier 3</b>
	are beyond the scope of the information presented here but can be found within the prospectus of Carrier 1.	upon annuitization and there is a maximum annuity commencement date.	

It is important to note the variances above, which we have derived from prospectuses of Variable Annuity plans offered by Carrier 1, Carrier 2, and Carrier 3.

\*The point of death plays an integral part in defining not only if a Minimum Death Benefit will be paid out, but additionally is vital in defining the methods of payment that are possible.

\*\*The Due Proof of Death under this option refers to a certified death certificate showing manner of death, certified decree of a court of competent jurisdiction as to the finding of death, a written statement by a medical doctor who attended the deceased, and any other proof satisfactory to the company.

\*\*\*The annuity payment option simply represents the form of the income payout a contract owner chooses to receive during the income phase or the phase that annuity payments are actually made.

† An income plan is simply how a contract owner chooses to receive annuity payments.—

‡ Cash settlements are received either through lump sum check or through use of a Northwestern Access Fund. The Northwestern Access Fund is an account opened in the name of the beneficiary, upon which a book of drafts, which function as checks from a checking account, are given to the beneficiary to draw upon the funds of the Death Benefit by writing a draft for all or part of the amount in the Death Benefit.

In addition to the basic Minimum Death Benefit feature, many variable annuity contracts feature riders that may be elected for additional costs in order to provide enhanced death benefits. The table below provides guidance to the different death benefit rider options available with a Carrier 1, Carrier 2, and Carrier 3 variable annuities. Furthermore, this table provides information regarding costs, features, and availability of the different death benefit rider options.

We have taken products from 3 major and well respected carriers and discussed them in this book using the names Carrier 1, Carrier 2 and Carrier 3 instead of the names of the actual life insurance companies. The identities of the actual insurance companies can be obtained by contacting Alan Gassman at [agassman@gassmanpa.com](mailto:agassman@gassmanpa.com)

Death Benefit Rider			
Carrier 1			
	Cost	Benefit Calculation	Availability
Highest Daily Lifetime Income v2.1 with Highest Daily Death Benefit	1.50%*	There is no guaranteed growth rate associated with this Benefit feature. Once elected, the Death Benefit will initially equal your account value. However, on subsequent valuation dates, the benefit will be the greater of: (1) the account value on that valuation date; or (2) the Highest Daily Death Benefit amount of the immediately preceding Valuation Day, increased by purchase payments made and reduced by withdrawals on the current Valuation Day.	This Death Benefit is similar to the Minimum Death Benefit described above, and is only available until either guaranteed payments are made under the Living Benefit rider selected or the annuity payments start.
Spousal Highest Daily Lifetime Income v2.1 with Highest Daily Death Benefit	1.60%*	There is no guaranteed growth rate associated with this Benefit feature. Once elected, the Death Benefit will initially equal your account value. However, on subsequent valuation dates, the benefit will be the greater of: (1) the account value on that valuation date; or (2) the Highest Daily Death Benefit amount of the immediately preceding Valuation Day, increased by purchase payments made and reduced by withdrawals on the current Valuation Day.	This Death Benefit is similar to the Minimum Death Benefit described above, and is only available until either guaranteed payments are made under the Living Benefit rider selected or the annuity payments start.
Carrier 2			
	Cost	Benefit Calculation	Availability

Return of Premium Death Benefit	An additional annual charge of 0.20% is applied to the most current version of this benefit.**	With this Death Benefit option, the Death Benefit will be the greater of: (1) the value of the Contract on the date Due Proof of Death and the required completed company documents are sent in by the beneficiary; or (2) the sum of all premium payments, less adjusted partial withdrawals and any premium taxes.	The most current version of this benefit is available for contracts purchased on or after October 19, 2011. Other versions of this benefit are available prior to this date at a smaller annual cost amount. Additionally, all forms of this benefit require the annuitant to be age 75 or younger at the time of purchase of the contract.
Annual Step-Up Death Benefit	This Benefit rider required an additional annual charge of 0.12% assessed only until the annuitant's 80th birthday.	Under this option, the Death Benefit will be the greatest of: (1) the value of the contract on the date of Due Proof of Death and the completed company forms are received; (2) the sum of all the premium payments less adjusted partial withdrawals and premium tax amounts; or (3) the highest account value on any contract anniversary date on or after election of the rider until the annuitant reaches age 80, plus subsequent premium payments less adjusted partial withdrawals and premium taxes subsequent to the election date.	This Benefit Option was only available on contracts entered into before October 30, 2010. It required annuitants to be age 69 or younger to elect.
Carrier 3			
	Cost	Benefit Calculation	Availability
Enhanced Death Benefit	The charge varies depending on the age of the annuitant and will change depending on this on the contract anniversary	The Enhanced Death Benefit Calculation provides a step-up in value every anniversary date based on the highest value of the account value on any anniversary date, and will also increase with additional purchase payments while decreasing with withdrawal values.	The Enhanced Death Benefit is only available at the time of initial purchase of the contract. Additionally, though lacking in detail regarding the Benefit, simply for accounting for the cost limitations, the benefit looks to only be available for contract purchasers age 65 and below.

	<p>date. The charge is 0.10% for issue age 45 or less, 0.20% for issue age 46-55, and the charge will be .40% for issue ages 56-65.</p>		
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\* Carrier 1 has the right to increase the costs charge of their Living Benefit rider with the attached increased Death Benefit from the percentages listed above to 2.00% upon a step-up under the Living Benefit.

\*\* The previous charges associated with this Death Benefit rider equaled an additional annual charge of 0.05% rather than the additional annual charge of 0.20% listed above.

**Can Annuities Continue To Be Safely Held By Irrevocable Trusts Having Multiple Beneficiaries? A Significant Risk Taken By Many Unsuspecting Contract Holders and Advisors.**

Annuity contracts are normally designed to be held by individuals, but individuals are frequently advised to use trusts which are or will become irrevocable to preserve assets for tax and other purposes. When irrevocable trusts hold annuities, a number of catastrophic problems can occur as discussed in this chapter.

Annuities held by or payable to a revocable trust during the lifetime of a grantor will be treated for tax purposes as if they are owned by the grantor, although state law creditor protection might be compromised if a Statute protects individual owners and beneficiaries but not trusts.

Irrevocable trusts may be disregarded for income tax purposes, in which event annuity contracts owned by such trust will be considered as owned by the grantor or a beneficiary depending upon which “grantor trust” rules apply.

Irrevocable trusts may also be “complex trusts” which are taxed as separate taxable entities in their own income tax brackets, the highest bracket of which is presently 39.6% on income not distributed that exceeds \$12,150 a year. The 3.8% Medicare tax also applies above the \$12,150 threshold for undistributed trust income.

If an irrevocable trust requires that all income be distributed annually to the income beneficiaries, then the trust may be a “simple trust” for federal tax purposes.

Under Section 72(u) annuity contracts must be held by natural persons, or by an agent for a natural person. Private Letter Rulings 9204014 and 9204010 concluded that annuity contracts owned by trusts for specified individual beneficiaries would be treated as being owned by “natural persons” for tax deferral purposes. In these Rulings, the IRS ruled that where a non-grantor trust that has only

one individual beneficiary holds an annuity contract, the contract can be treated as owned by a natural person.

Since then, a number of Private Letter Rulings<sup>26</sup> have come to the same conclusion, but none of these rulings (except possibly for one of them<sup>27</sup>) have stated that an irrevocable trust that benefits multiple beneficiaries can be the owner of a tax-deferred annuity where the trustee has the ability to “spray” income and/or principal among multiple beneficiaries.

In addition, the IRS has not yet ruled on whether an unborn person is a “natural person” for the purposes of Section 72(u), which can be an important issue if a trust holding an annuity contract does not pay out to individual beneficiaries, but instead is held for the benefit of future generations indefinitely (or at least until the perpetuities period runs). However, Private Letter Rulings 199933033 and 200449016 suggest that unborn heirs are considered “natural persons.”

Most of the Private Letter Rulings have been based upon factual scenarios where the trust documents specifically require that any one or more annuity contracts will be used solely for one named beneficiary, and in many of the Rulings the contract itself is to be transferred to the one individual beneficiary that the contract has been purchased to benefit. For example, Private Letter Ruling 201124008 allowed a multiple beneficiary trust to hold multiple annuity contracts, but the trust required that each separate contract was designated for a separate individual beneficiary, and that each contract would eventually be distributed to the designated beneficiary. It is not known why each of the Letter Rulings was couched in these terms.

Private Letter Ruling 9752035 also allowed a multiple beneficiary trust to hold an annuity contract, but the terms of the trust provided that the trust was to be divided into separate shares for each of the remainder beneficiaries, and that all income from each share is to be distributed to an income beneficiary who is named in the trust. The terms of the trust also gave the trustee the power to distribute corpus based upon an ascertainable standard to the named income beneficiary or the remainder beneficiaries in accordance with their respective proportionate shares in the trust. Although this Ruling provides minimal discussion, the terms of the trust did not appear to permit the trustee to make discretionary distributions of assets to the trust beneficiaries without regard to their respective separate shares.<sup>28</sup>

Where the trustee of a non-grantor trust can spray income to one or more beneficiaries the law is less clear, particularly where the trust may benefit future born beneficiaries who are not yet living.<sup>29</sup> A typical generation skipping or spendthrift irrevocable trust will not provide that any significant assets (including trust income) will be distributed to a beneficiary, except as needed for health, education, maintenance and support. It is unknown whether the IRS would allow an irrevocable trust that provides health, education, maintenance and support benefits for multiple beneficiaries to qualify in the same manner as these Rulings have permitted.<sup>30</sup> Apparently none of the

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26 PLRs 199905015, 9752035, and 200449016.

27 PLR 199933033.

28 See also PLR 200626034.

29 Underwood, J. Gary. “Trust Ownership of Nonqualified Annuities: General Considerations for Trustees.” P. 3. <http://www.financialpro.org/pubs/subs/journal/2010/05/j00310a2.cfm>. Journal of Financial Service Professionals. May 2010. See also PLR 9752035.

30 See PLR 199933033, in which the IRS concluded that the annual contract was owned by a natural person for the purposes of § 72(u)(1) where distributions from an irrevocable complex trust to a particular beneficiary were limited to amounts necessary to provide for the beneficiary’s health, education, maintenance and support, as determined by the trustee. However, this Ruling involved a trust with one particular beneficiary, and it is not clear whether the IRS would have come to the same conclusion if the trust allowed for discretionary distributions to multiple beneficiaries.

trusts that are the subject of these Rulings have had multiple generations of beneficiaries that include unborn heirs as possible beneficiaries of an annuity contract.

### **Can a Complex Spray Trust Qualify as a “Natural Person” to Hold an Annuity Contract and Facilitate Deferral of Income?**

Many complex trusts exist as separate taxpayers, and are subject to income tax at the 39.6% bracket to the extent of income that is not distributed and exceeds \$12,150 per year. In addition to this, the income will be subject to the 3.8% Medicare tax, bringing the tax rate to 43.4% for ordinary income.

Can a complex trust purchase a variable annuity product, and defer income until withdrawals occur? Typically with a variable annuity contract distributions do not need to occur until after the death of the annuitant, or the surviving annuitant if the contract has one or more annuitants.

The question becomes whether a complex trust can be considered to be a “natural person” under Internal Revenue Code Section 72(u). While it does seem clear that multiple individuals can be considered as one “natural person” under this definition, there is no court case, regulation, Revenue Ruling, or other binding guidance from the IRS on whether a complex trust that benefits multiple beneficiaries on a discretionary basis can qualify for tax deferral by use of a variable annuity. If not, then all net growth within the variable annuity will be considered ordinary income to the complex trust, which can be catastrophic.

As described above, several Private Letter Rulings have allowed complex trusts to own annuity contracts and to facilitate income tax deferral, but all of these, except possibly for one, have noted that the trust in question does not have discretion to distribute property. However, Private Letter Ruling 199933033 may be read to allow a complex trust to hold one annuity contract for multiple beneficiaries where the trustee has discretion to distribute property among the beneficiaries based upon an ascertainable standard. On the other hand, this Ruling did not discuss whether the trustee would have the power to make discretionary distributions to one or more trust beneficiaries without regard to the respective separate shares of the beneficiaries. Both arguments are explored in this chapter.

### **Argument Against the Private Letter Ruling Allowing a Spray Power**

Private Letter Ruling 199933033 involves a trust that has three different phases. The first phase occurs when the grantors’ son (“S”) is alive. The Private Letter Ruling states that “[the] Trust will continue for S’s lifetime and will terminate upon S’s death.” When S is alive, S is the only beneficiary. Per the terms of the Trust Trustee must make all distributions, if any, to S, who is the only beneficiary during his lifetime. While the Trustee has discretion regarding the amount of the distribution, the Trustee does not have discretion to distribute property to another beneficiary, or the discretion to distribute assets to one beneficiary to the exclusion of another.

The second phase occurs if S has descendants. If S dies and has living descendants, then “subtrusts’ for such descendants will be created at the time of [S’s] death,” one for each descendant. Each descendant will receive distributions from his or her own subtrust. Therefore, each subtrust will have only one beneficiary. While the Trustee has the discretion to determine the amount of the distribution, the Trustee does not have the discretion to distribute more or less property to another beneficiary.

The third phase occurs if S does not have descendants. If S does not have descendants, then the “unappointed Trust property will be distributed (generally, outright) to relatives of the Grantors (or S).” Further, the Private Letter Ruling explains that “if S has no descendants living at the time of his death, there will be a per stirpes distribution of Trust property distribution (sic) to the descendants of the Grantors.” In other words, the Trust terminates and its assets are distributed outright and free of trust.

The Private Letter Ruling indicates that the Trustee may distribute property to S or his descendants, and this language might mean that the Trustee may distribute property to S, or that the Trustee may distribute to S’s descendants after S dies.

S has the ability to appoint by Will, or after attaining a certain age specified in the Trust by separate document, “all or any part of the property remaining in Trust” to any person who is related to him by blood, marriage, or adoption. Because the Trust specifically says that this power applies to “all or any part of the property remaining in Trust”, this can be read as giving S the ability to distribute the Trust property as he desires upon its termination. In other words, only when the Trust terminates, S can determine the amount of the property that is to be distributed to any person related to S by blood, marriage or adoption. This is supported by the prior statement, which provides that “if S has no descendants living at the time of his death, there will be a per stirpes distribution ... to the descendants of the Grantors unless S has exercised his special power of appointment.” This implies that S’s power of appointment applies to distributions made pursuant to the Trust’s termination.

#### **Argument For Allowing a Spray Power**

Private Letter Ruling 199933033 may allow for the Trustee to be able to make discretionary distributions of assets to the Trust beneficiaries, and still have an annuity contract held by the Trust be considered as being held by a “natural person” for the purposes of Code Section 72(u). The key issue lies within phase two of the Trust, the portion of the Trust which explains the Trustee’s power of distribution to S or his descendants.

The Trust is not clear as to whether the Trustee has the power to make discretionary distributions to one or more beneficiaries without regard to their respective beneficial shares in the Trust while the Trust is in its second phase. Specifically, the Trust provides that, at a specified age, S will replace Grantors as Trustee of Trust and have a, “...special power of appointment by will (or after [a specified age] by separate document) of all or any part of the property remaining in Trust to any person related to S by blood, marriage or adoption.” Therefore, S, as Trustee, appears to distribute all or any part of the property in the Trust to certain parties by way of a separate document after he attains the age specified in the Trust document. It is important to note that should S die and have descendants, separate subtrusts would be created for such descendants in lieu of the exercise of S’s power of appointment.

Furthermore, the Ruling states that “...Trust allows for the Trustee to distribute to the beneficiary of the Trust (e.g., S or his descendants) such amounts of income and principal of Trust as are necessary... to provide for the beneficiary’s health, support, maintenance and education, taking into consideration age, education and station in life.”[emphasis added]. This language is vague, and does not provide guidance on whether the Trustee could distribute to Trust property to one or more of S and his descendants. It could be read that S, as Trustee, can distribute property to either himself or one or more of his descendants as long as the requisite factors are considered. However, it could also be read to allow the Trustee to only make distributions to S, or to the applicable descendant of S that is a beneficiary of a subtrust created under the Trust after S’s interest terminates.

It remains unclear whether the trigger for distribution under the trust requires S to be deceased or if the Trustee has discretion to distribute income to S, his descendants, or both. If S's death is not a trigger for distribution, then the Trustee should be able to distribute the Trust property to multiple beneficiaries at its discretion, based upon the standard set forth in the Trust instrument. Although the Trust provides that S's special power of appointment may be exercised by will, it also indicates that S was able to exercise such power of appointment by a "separate document" once S attains a certain age. This suggests that, while living, S can distribute Trust property to parties related by "blood, marriage, or adoption." It appears that this language does not require the Trust to be terminated or S to be deceased in order for discretionary distributions to be made to multiple beneficiaries. As such, the Trustee appears to have the discretion to spray income and principal amongst the trust beneficiaries.

No matter which side you fall on, this Ruling is vague when explaining the Trust and how it functions. However, the Ruling is not vague in its conclusion that the Trust could hold the annuity contract as a natural person for the purposes of Code Section 72(u).

One item to note is that the applicants for the Ruling represented that all of the contingent beneficiaries will be natural persons. What if a charity is a potential contingent beneficiary if none of the involved individuals survive? There is no authority directly on point.

It would be most prudent to obtain a Private Letter Ruling in any situation where a significant amount of income will be earned under an annuity arrangement where the owner of the contract is a trust with multiple beneficiaries with an indefinite term, especially if it is a discretionary sprinkle or spray trust.

### **Can a Withdrawal From an Annuity Escape the 10% Excise Tax if Distributed to a Beneficiary of a Trust Over 59 ½ Years of Age?**

An additional issue that arises is whether the 10% excise tax under Section 72(q)(1) is imposed on distributions of annuity payments to a trust, if the trust is holding an annuity contract as nominee for natural persons as described above. There is currently no IRS guidance on this.

As described in Chapter 2, Section 72(q)(1) provides that taxable income from an annuity is subject to an income tax rate 10% higher than the rate that would otherwise apply, unless certain exceptions apply. Section 72(q)(2) lists the exceptions to the 10% excise tax that apply where a taxpayer receives a distribution from the annuity contract, which are as follows:

1. An individual taxpayer receives the distribution after reaching age 59½;
2. The taxpayer receives the distribution from an immediate annuity;
3. The taxpayer receives the distribution after the death of the owner of the contract;
4. The taxpayer receives the distribution based upon becoming disabled; or
5. The taxpayer receives the distribution as part of a series of substantially equal periodic payments, made at least annually, for the life of such taxpayer and his designated beneficiary.

Annuity distributions are reported on Form 1099-R, which is required to be attached to the recipient taxpayer's income tax return. Box 7 of Form 1099-R requires the insurance company to indicate whether a "known exception" to the 10% excise tax applies. If a complex trust is the



recipient of a distribution, and the individual beneficiaries of the trust otherwise qualify for an exception, then the “no known exception” box might apply, and the excise tax will be imposed.

The IRS’ arguments that there is no exception to the 10% excise tax when distributions are made to a complex trust are as follows:

1. The trust files a fiduciary income tax return each year. Annuity distributions reported on the insurance company’s Form 1099-R are included in the return. When the trust reports the income, it increases the trust’s gross income.
2. The payments are controlled by the named owner of the annuity, which is the trust. Thus, it is the trust that receives the annuity payment and is the party required to qualify for the exception. Even if the trustee made the payment directly to the trust beneficiary, the fact that the trustee has control over the payment gives the trustee constructive receipt.
3. The trust may distribute proceeds from the trust to the beneficiary. In doing so, it claims a deduction on Schedule B and transposes the deduction to the Form 1041. These deductions are reportable to the beneficiary as taxable income on Schedule K-1. There is no line to specifically characterize such a distribution as an annuity distribution; it must be taken as “other portfolio and non-business income.”
4. As a result, the trust reports the annuity distribution in arriving at the trust’s total income, which meets the requirement for the penalty tax to be due under Section 72(q)(1). Since the trust has no age it cannot meet the exception for being 59 ½.
5. Annuities get favorable tax treatment to encourage retirement savings. It is for this reason that non-natural entities are not permitted to have tax deferral under Section 72(u). Congress saw fit to carve out an exception under Section 72(u) to cause a loss of tax deferral for trusts and other non-natural owners when holding an annuity for the benefit of natural persons. Similarly, Section 72(s), relating to distributions after the death of the holder, if the annuity start date has already occurred and before the entire interest in the contract is distributed, allows for substitution of the annuitant for the holder for application of that subsection when the annuity is held by a non-natural entity. This shows that Congress contemplated that a trust could and would hold an annuity. The fact that they did not make an exception to the 10% tax for trusts cannot be a mere oversight.

It is a basic precept that when the Code can be interpreted in different ways, the method with the plainest reading is the one to be followed. The language of Section 72(q) implies that the only exception that the trust would qualify for is the immediate annuity exception.

Arguments for the proposition that the 10% excise tax should not apply if a beneficiary of a trust who is over age 59 ½ receives all of the monies distributed are as follows:

1. The trust has no age, so you must substitute the life or lives of its beneficiaries (with respect to the age 59 ½ exception).
2. Use the life of the annuitant, rather than the contract holder. This is the approach of Section 72(s)(1)(A) where the holder of the annuity dies after the annuity start date, but before the entire interest in the contract is distributed. Unfortunately, the substitution of the contract beneficiary for the contract holder appears to be specifically limited to Section 72(s)(1)(A), and there is no language that permits this process to be used under Section 72(q).

3. Use the life of the trust beneficiary. The annuity proceeds pass from the trust to a beneficiary, who in turn reports the income as taxable. Since the beneficiary reports the income, this is the life that matters for Section 72(q) purposes. One insurance company has cited Private Letter Ruling 199905015 to support this. This Private Letter Ruling indicated that the distribution of an annuity contract from a trust to its beneficiaries is not a taxable event. Therefore, the gain recognition rules of Section 72(e)(4) should not apply. Private Letter Ruling 201124008 clarifies this point, although like Private Letter Ruling 199905015, it also makes no mention of Section 72(q).

However, there are critical flaws to this argument which include the following:

- A. For this argument to work the distribution would have to in fact be distributed from the trust. The insurance company is obligated to issue 1099s to the best of their ability based on reasonable interpretation of the tax code. The insurance company has no audit trail to determine whether the trustee gave the money to a trust beneficiary or not and, if they did, how old they are.
- B. At least one company attempts to solve this by having the trustee sign a hold harmless agreement specifying that the trust beneficiary is over 59 ½. The insurance company is obligated to the IRS to fill out the 1099s to the best of their ability, and there is no authority for it to offload this responsibility to some third party that has a monetary interest in the reporting outcome.
- C. This argument requires some assumptions that are not required in the opposing argument (that the penalty tax is simply due). As stated earlier, the simplest, plainest reading of the law is the one that prevails.

In any event, the treatment of this issue is far from clear. For further details on the Private Letter Rulings concerning trusts as annuity owners, see the Chart Comparing Private Letter Rulings as Annuity Owners in Chapter 14.

### **The Immediate Annuity Exception**

The only sure way to avoid the excise tax uncertainty for an annuity held by a trust that is treated as a separate entity (a “simple trust” or a “complex trust”) is to rely on the immediate annuity exception to the 10% excise tax under Section 72(q)(2)(I), but an immediate annuity by definition must begin the annuitized annual payments within one year of the annuity purchase.

The formal requirements are as follows:

1. The annuitized cash flow begins within one year of the annuity purchase;
2. The contract is purchased with a single premium; and
3. The method of calculating payments is not changed from one year to the next.

It is therefore not possible to take a variable annuity that has been owned for more than one year and exchange it tax-free into an immediate annuity to avoid the 10% excise tax, as discussed above.

Private Letter Ruling 200818018 found that the Lincoln i4LIFE® Advantage rider meets the Section 72(q)(2)(I) exception, notwithstanding that the annuity can have the economics of the arrangement based upon the performance of the mutual funds held in the “subaccount” under the annuity, and the owner of the contract can make changes to the payment designations during the “Access Period” discussed above. As a result, a trust may be able to take advantage of tax deferral and avoid the 10% excise tax on income, while also having the benefit of guarantees, if and when they are appropriate, based upon the immediate annuity exception.

### **Lifetime Gifts of Annuities Can Trigger Deferred Income**

The Tax Relief Unemployment Insurance Reauthorization, and Job Creation Act of 2010 increased the applicable exclusion amount from \$1,000,000 to \$5,000,000 for tax year 2011 and Revenue Procedure 2011-52 increased the exclusion amount to \$5,120,000 for tax year 2012. The 2014 exclusion amount is \$5,340,000. This increase has created interest in gifting programs. Some clients looking for assets to give away may look at annuity contracts, particularly if the donee of the annuity is in a lower tax bracket. Often, these are contracts that have accumulated gains that the clients have no intention of spending.

The transfer of an annuity will generally cause the transferor to be subject to income tax as if all of the deferred income in the annuity had been withdrawn. This is treated as ordinary income to the donor at the time of the transfer. In other words, Section 72(e)(4)(C) provides that if a deferred annuity contract is transferred without adequate consideration, then a deemed distribution of the built-in gain in the contract gain occurs to the donor. An exception applies when the donee is a spouse or the transfer is made incident to a divorce. The donee or divorced recipient spouse will have the same investment in the contract as the donor spouse had.

The 10% excise tax can also apply to the gift of a deferred annuity contract. If the annuity has been deferred, the immediate annuity exception of Section 72(q)(2)(I) is not available. Therefore, a possible solution to avoid the recognition of the built-in gain and the 10% excise tax to the donor is to annuitize the contract, and then make the gift.

If the donee is over the age of 59 ½, then the Section 72(q)(2)(A) exception to the 10% excise tax applies. Here, any measuring life can be used. If the contract in question is a so-called “owner driven” contract, then the annuitant can be changed before the contract is gifted to cause the measuring life to be an individual who is over the age of 59 ½. If the existing contract is “annuitant driven,” then changing the annuitant would result in a taxable event. There are two possible solutions to this issue: (1) annuitize the contract under the existing structure; or (2) implement a tax-deferred 1035 exchange to an owner driven company and then change the annuitant. Many carriers, including Lincoln Financial Group, allow a change of the annuitant.

If the donee is under age 59 ½ then he can rely on the Section 72(q)(2)(D) exception to the 10% excise tax. Section 72(q)(2)(D) states that if the contract distributions are part of a series of substantially equal periodic payments made for the life or life expectancy of the taxpayer, or the joint life of the taxpayer and his designated beneficiary, the 10% penalty does not apply.

## **Section 1035 Exchanges**

Section 1035 allows life insurance contracts, endowment contracts, and annuities with built-in income to be exchanged for annuity contracts on a tax free basis.<sup>31</sup> The resulting contract has the same investment in the contract as the contract for which it is exchanged. Tax-free treatment is also available in partial exchange situations. According to the Securities and Exchange Commission, a 1035 exchange may be useful if there is another annuity with features that an investor prefers, but the investor may be required to pay surrender charges on the old annuity if it is still within the surrender charge period. Advisors can do their clients a service by tracking surrender charge expiration dates and reminding clients of exchange opportunities. The SEC cautions consumers that with 1035 exchanges, the annuities need to be compared carefully as to change in fees, different surrender periods, and ensuring the exchange is tax-free. If an old annuity is surrendered for cash and then a new annuity is bought, the consumer will be required to pay tax on the surrender. (SEC - Variable Annuities: What You Should Know.)

The SEC further states that, “even if the surrender period on [the] current annuity contract has expired, a new surrender period generally will begin when [the consumer] exchanges that contract for a new one. This means that, by exchanging the contract, [the consumer] will forfeit [his or her] ability to withdraw money from [his or her] account without incurring substantial surrender charges.”

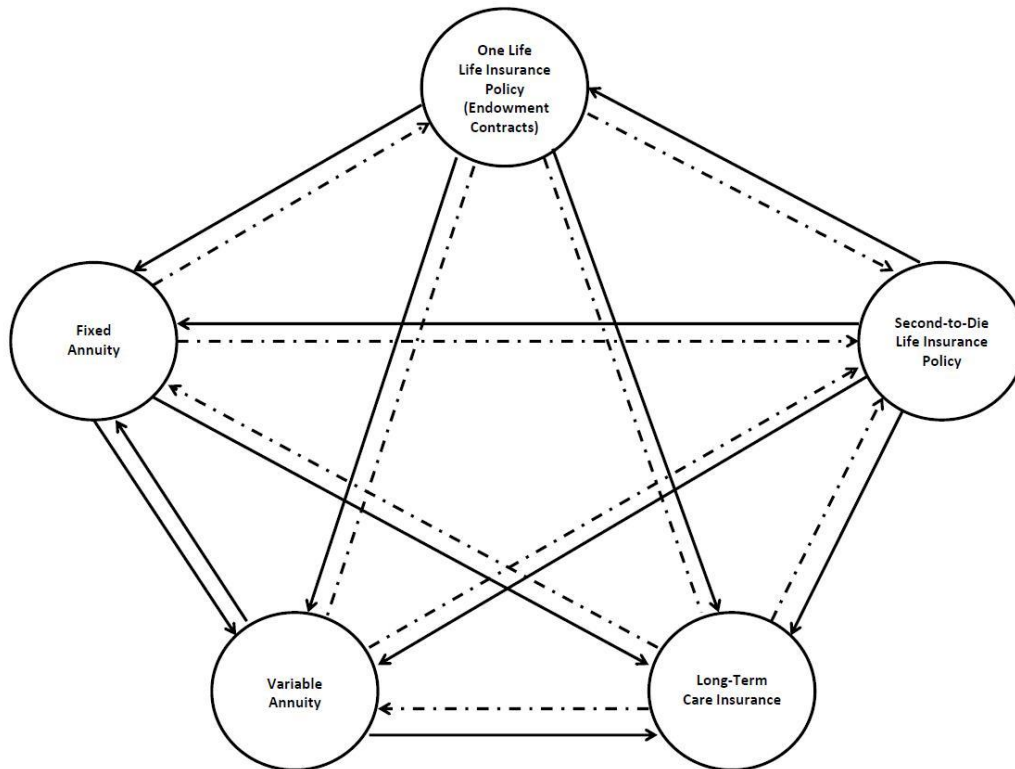
The chart below provides a graphic representation of which financial products can be exchanged on a tax-free or tax-deferred basis under Section 1035. As indicated by the chart, Section 1035 allows for a life insurance contract to be exchanged into any of the other listed contracts (i.e. other life insurance policies, endowment contracts, annuity contracts, or long-term care insurance contracts). However, a life insurance policy on one life cannot be exchanged for a life insurance policy that pays on the death of the survivor of two individuals (a second-to-die life insurance policy). Furthermore, endowment contracts may only be exchanged for other endowment contracts, annuities, or long-term care insurance contracts.<sup>32</sup> Long-term care contracts are the most restricted, in that they can only be exchanged for other long-term care contracts. Some variable annuity products provide that minimum annual payments may be doubled if the annuitant would qualify for long-term care benefits. These annuities presumably can be exchanged for other annuities under Section 1035, and the benefit is very limited if all payments under the contract reduce the actual cash value of the contract.

The straight lines in the chart indicate that tax-free exchange treatment under Section 1035 is permitted, while the dotted lines indicate that tax-free exchanges are not available under Section 1035.

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31 Section 1035(a) provides that “no gain or loss shall be recognized on the exchange of B(1) a contract of life insurance for another contract of life insurance or for an endowment or annuity contract or for a qualified long-term care insurance contract; or (2) a contract of endowment insurance (A) for another contract of endowment insurance which provides for regular payments beginning at a date not later than the date payments would have begun under the contract exchanged, or (B) for an annuity contract, or (C) for a qualified long-term care insurance contract; (3) an annuity contract for an annuity contract or for a qualified long-term care insurance contract; or (4) a qualified long-term care insurance contract for a qualified long-term care insurance contract.”

32 Section 1035(b)(1) defines an endowment contract as “a contract with an insurance company which depends in part on the life expectancy of the insured, but which may be payable in full in a single payment during his life.” Additionally, according to the Individual Retirement Plans Guide, an endowment contract “is an annuity contract that also provides life insurance protection.” Wolters Kluwer Law & Business (Firm). Individual Retirement Plans Guide: Individual Retirement Accounts and IRA-Related Savings Vehicles: Traditional IRA Contributions: Amounts Paid under Endowment Contracts, CCH-IRPGD P 1370 (CCH), 2009 WL 3925710 (2013). These contracts essentially result in a deferred payout to owners resulting after the premiums on the contract have been paid.



Treasury Regulation 1.1035-1 provides that Section 1035 will not apply in situations where the contract or policies that are exchanged do not involve the same insured or obligee. However, Section 1035 allows for the exchange of multiple contracts, meaning that two life insurance policies may be exchanged for one annuity contract, or one annuity contract may be exchanged for two annuity contracts.

A deferred annuity cannot be exchanged for an immediate annuity. In Revenue Ruling 92-95, a taxpayer tried to exchange a deferred annuity for an immediate annuity. The taxpayer claimed that the exchange qualified for the immediate annuities exception to the 10% excise tax under Section 72(q)(2)(I). The IRS ruled that the new annuity contract would be considered as having been acquired on the date of the original annuity contract's creation. Therefore, the payments were not considered to begin within one year of the purchase date, and the contract was not an "immediate annuity" within the meaning of Section 72(u)(4).

Section 1035 exchanges must be "simultaneous," and no cash can be accessible to the taxpayer. One factor is the length of time that it takes to complete any non-simultaneous exchange when considering whether a Section 1035 tax-free exchange is available. Taxpayers are not faulted for delays caused by the insurance companies.<sup>33</sup>

The IRS requires that a new contract must be exchanged for the whole or part of an existing contract.<sup>34</sup> This means that a taxpayer cannot hold nor withdraw the proceeds of an existing annuity or life insurance contract to make the exchange by reinvesting the funds in a new contract.<sup>35</sup>

<sup>33</sup> According to the Fall 2009 MetLife newsletter, "Legal & Tax Trends," exchanges "do not have to be simultaneous in a literal sense." Furthermore, the newsletter indicates that the IRS will allow for understanding in relation to timing issues that the taxpayer was not in control of.

<sup>34</sup> In Rev. Rul. 2007-24, the IRS found that a taxpayer who received life insurance policy proceeds from the insurance company as a check, when an insurer would not directly transfer the funds to another insurer, did not meet the requirements of a § 1035 exchange. This was even

Section 1035 exchanges can also be completed by beneficiaries who inherit annuity contracts. Private Letter Ruling 201330016, released on July 26, 2013, paved the way for options for such beneficiaries. The taxpayer was the designated beneficiary on numerous variable and fixed annuity contracts owned by her mother. On her mother's death, the taxpayer elected to take the annuity payments over her life expectancy in compliance with Section 72(s)(2). Following the election, the taxpayer sought to exchange some of the inherited annuities for a new annuity, and receive tax-free treatment for the exchange. To accomplish this, the taxpayer had the funds directly transferred between the insurance companies, and completed forms that would limit the purchase payments for the new annuity to the funds found in the old annuity contracts exchanged.

The IRS found that this exchange was a valid Section 1035 exchange. It concluded that both contracts were annuity contracts, and that the transaction met the Section 1035 exchange requirements. Further, the IRS concluded that the taxpayer would be considered the owner of the original annuity contracts upon inheriting them. Therefore, the same holder requirement of a Section 1035 exchange was not violated.

A Private Letter Ruling is only binding on the taxpayer who requested it. While this Ruling provides positive guidance for the reliance of Section 1035 exchanges with respect to inherited annuities and life insurance policies, taxpayers must tread carefully until additional rulings or an official position is taken by the IRS.<sup>36</sup>

Annuity holders can transfer part of their annuity investment in the contract between their old annuity contract and a new annuity contract tax-free under Section 1035. In such a case, the investment in the contract is pro-rated or ratably distributed between the old and new annuity depending on the amount transferred within the Section 1035 exchange.

For example, if a taxpayer has a fixed annuity contract worth \$200,000 with an investment in the contract of \$50,000, the exclusion ratio is 25% ( $\$50,000/\$200,000$ ). If the taxpayer seeks to use \$40,000 of the contract for a partial exchange, so that the original contract will now only hold \$160,000 in value, then the original investment in the contract of \$50,000 must be pro-rated between the two contracts. This means the new contract will have an investment in the contract of \$10,000 and the old contract will have an investment in the contract of \$40,000.

The IRS was concerned that taxpayers would circumvent the LIFO rules through use of multiple annuity contracts and had aggregation rules enacted. Under Section 72(e)(12), multiple annuity contracts purchased by the same taxpayer from the same carrier in the same calendar year will be treated as if they were one contract for purposes of making withdrawals. This also prevented circumvention of the 10% excise tax under Section 72(q). If annuity contracts were treated as one insurance contract, then the new contract would still be subject to the 10% excise tax, unless the original contract met an exception to Section 72(q).

However, taxpayers began completing partial 1035 exchanges between different insurance companies for the purpose of avoiding the 10% excise tax under Section 72(q). Up until the 1998

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after the taxpayer sought to have the insurer make a direct transfer and had endorsed the check to the other insurer without cashing it first.

<sup>35</sup> The IRS adhered to this principle in PLR 200622020 where a taxpayer attempted to surrender an annuity, receive the proceeds of the surrender, and then purchase a new annuity under the guise of a 1035 exchange.

<sup>36</sup> LISI Employee Benefits and Retirement Planning Newsletter #624 (July 31, 2013) at <http://www.leimbergservices.com> Copyright 2013 Leimberg Information Services, Inc. (LISI). Reproduction in Any Form or Forwarding to Any Person Prohibited – Without Express Permission.

Tax Court case, *Conway v. Commissioner*,<sup>37</sup> the IRS did not recognize partial exchanges of annuities.<sup>38</sup> Following *Conway*, the IRS was still concerned with partial exchanges of annuities and the use of Section 1035 for tax-free treatment. To combat this concern, the IRS had indicated in AOD 1999-016 that they would challenge partial exchanges of annuity contracts where the new contracts are then annuitized in order to avoid the application of the 10% excise tax under Section 72(q).<sup>39</sup> Revenue Ruling 2003-76 provides guidance on how to accomplish a partial exchange involving an annuity.<sup>40</sup> Further guidance was issued by the IRS in Notice 2003-51, and Revenue Procedures 2008-24 and 2011-38. Notice 2003-51 provided interim guidance stating a 24-month consideration of tax avoidance for annuity surrender or distributions following Section 1035 exchanges.<sup>41</sup> Following 2003-51, Rev. Proc. 2008-24 was issued providing a two part consideration for Section 1035 exchanges.<sup>42</sup>

Finally, the IRS released Rev. Proc. 2011-38, which provided that, so long as withdrawals are not received from either contract for 180 days following a partial exchange, then the partial exchange will qualify as a tax free 1035 exchange. It reduced the 12-month period that was espoused by the IRS in Rev. Proc. 2008-24 to 180 days, and eliminated the requirement that an exception under Section 72(q)(2) must be met to obtain Section 1035 tax-free treatment.<sup>43</sup> The Rev. Proc. established that a partial exchange of annuity contracts will be tax-free under Section 1035 or “the Service will apply general tax principles to determine the substance of the transfer and, therefore, its tax treatment.”<sup>44</sup> Further, the original contract and the new contract are not aggregated after the 180 day period, notwithstanding whether they are issued by the same carrier.

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37 111 T.C. 350 (1998)

38 Petitioner was arguing that the exchange of part of one annuity to a new annuity was a tax-free exchange under § 1035, even after surrender charges were taken from her contract. The IRS argued that taxpayers could not do partial exchanges with annuities under § 1035. The Tax Court held that the exchange met the requirements for a 1035 exchange, finding that all that was required was the same obligee and the same type of contract for an annuity transfer.

39 One concern arises from the treatment of immediate annuities in relation to the 10% penalty imposed by § 72(q). This penalty does not apply to annuities that are considered immediate annuities, under § 72(q)(2)(I), or an annuity, defined in § 72(u)(4)(B), that “commences no later than 1 year from the date of the purchase of the annuity.” Thus, if an annuity is exchanged in a partial exchange, meeting the requirement of § 1035, and is considered as a separate annuity with a separate issue date, the taxpayer could avoid the application of the additional 10% penalty under § 72(q), if they were to start taking annuity payments to classify the annuity as an immediate annuity. However, this would only work if the new annuity is considered to have a separate issue date from the original annuity. The IRS will seek to have the contracts be considered as one contract, and as such, the new contract will carry the old contracts issue date rather than having the new issue date.

40 Rev. Rul. 2003-76 found that although an existing annuity continues on, a taxpayer can have § 1035 tax-free treatment for an exchange of part of the existing annuity for a new annuity, and the investment in the contract will be allocated proportionately among the two resulting annuities based on the cash value of the original annuity prior to the exchange taking place.

41 In Notice 2013-51 the IRS stated that the “Treasury and the Service are considering whether to treat surrenders or distributions that occur within 24 months of the date on which the partial exchange was completed as presumptively entered into for tax avoidance purposes.”

42 Rev. Proc. 2008-24 states that a transfer “will be treated as a tax-free exchange under 1035 if either—(a) no amounts are withdrawn from, or received in surrender of, either of the contracts involved in the exchange during the 12 months beginning on the date on which amounts are treated as received as premiums or other consideration paid for the contract received in the exchange; or” the taxpayer can show that one of the exceptions to the premature distributions penalty, under §72(q)(2), have been met, “or any similar life event (such as divorce or loss of employment)”, has occurred during the period of the initial partial exchange and the point that a withdrawal or surrender is made.

43 Rev. Proc. 2008-24 states that a transfer “will be treated as a tax-free exchange under 1035 if either—(a) no amounts are withdrawn from, or received in surrender of, either of the contracts involved in the exchange during the 12 months beginning on the date on which amounts are treated as received as premiums or other consideration paid for the contract received in the exchange; or” the taxpayer can show that one of the exceptions to the premature distributions penalty, under §72(q)(2), have been met, “or any similar life event (such as divorce or loss of employment)”, has occurred during the period of the initial partial exchange and the point that a withdrawal or surrender is made.

44 Howard M. Zaritsky & Stephan R. Leimberg, *Tax Planning with Life Insurance: Analysis with Forms*, Chapter 2 Income Taxation of Life Insurance, at ¶2.17[2] (Thomson/RIA 2012).

It is important to note that Rev. Proc. 2011-38 replaced Rev. Proc. 2008-24, and applies to transactions completed on or after October 24, 2011. Rev. Proc. 2008-24 remains in effect for transfers completed before that date.



## **CHAPTER 8**

### **STRUCTURED SETTLEMENT ANNUITIES**

Under Internal Revenue Code Section 104, an injured taxpayer may receive a structured annuity payment right backed up by a fixed or specially designed insurance contract that makes payments over time with an investment return, which are not subject to income tax. In most cases, the insurance company that pays for the settled claim will introduce an annuity carrier to the injured taxpayer and not inform the taxpayer or their legal counsel that there may be more competitive products available. Worse, the insurance carrier paying the claim will commonly receive a commission or kickback from the annuity carrier that provides the structured settlement contract.

Well educated plaintiff lawyers will typically consult with an independent structured settlement agent who can evaluate and compete against proposals given by the defendant carrier's recommended companies. Typically, the ultimate settlement may involve a joint product sale by the agent who is representing the plaintiff and the agent who represents the insurance carrier once they have agreed on the most appropriate and competitive contract or contracts.

“Even the most competitive bid will not satisfy client needs if structuring does not take into account tax planning, creditor protection, spend thrift protection, family budgeting, and other factors relating to the client's financial, estate planning, and legal concerns. Proper coordination with the client's other advisors, and making sure that there is a proper team of advisors, is essential. See: Alan S. Gassman and Randal E. Gassman, “Structured Annuities: What Every Plaintiff's Lawyer Should Know” *The Practical Litigator*, Vol. 9, No. 3 (May 1997).

Large personal injury settlements and class action personal injury suits will commonly be settled by the funding of a Qualified Settlement Fund that can later be directed into structured annuities, cash, and other hybrid sources so that the injured taxpayer or taxpayers have time to make appropriate financial decisions and arrangements after the final settlement with the defendants has occurred.

It may also be possible for plaintiff lawyers to defer paying income tax on contingency fees by accepting long-term payment annuities in lieu of immediate payment.

Tax and estate planning lawyers who have clients being represented as plaintiffs in personal injury lawsuits should consider asking litigation counsel to arrange in advance to have an independent agent who regularly represents injured individuals in structured settlement annuity placements available to attend mediations and settlement conferences. Such independent agent should have advanced information on the plaintiff's health and life expectancy in order to help assure that the plaintiff is reviewing the best available options for a structured settlement annuity product. Oftentimes, a contract that provides payments over the lifetime of the payee will be a more attractive structure, and different carriers will have different life expectancy assumptions based upon the specifics of the health of a particular plaintiff. The defendant's insurance company has little or no interest in trying to help assure that a plaintiff receives the most competitive contract available.

## **CHAPTER 9**

### **EQUITY-INDEX ANNUITIES (EIA)**

Now that the “income guarantee” products are more exposed for high direct fees and what the authors consider to be misleading sales techniques, the industry has ramped up new and often difficult to understand variable hybrid products called “equity-indexed annuities.”

When the annuity industry found out that people did not want to pay 3%, 4%, or more in annual fees for the income guaranteed products, they switched to what they call “equity-index” products.

Under an equity indexed annuity, the policy holder can select a well-recognized financial market index, like the S&P 500, Russell 2000, or the Wilshire 5000, and the contract will provide a rate of return each year based upon calculations that are derived from the index, but use “caps” and other calculation methods that yield a significantly lower return than the actual index, while also providing a floor each year to prevent losses below zero. They do this by using complex concepts such as point to point measurements, the spreads, and ceiling provisions as described below.

Typically the contract provides that if the index is negative for a given period of time, then the value of the contract will not go down, but if the index is positive then the value of the contract will go up ONLY by some portion thereof.

For example the company may say “We will put your money, or the equivalent thereof, into an S&P 500 Index, or a NASDAQ Index, or a Morgan Stanley Index, and we promise you that if during a contract year the index goes down we will keep you at zero and you will never lose your principal.” That seems straightforward and easy to understand.

However, this is not the whole picture. In exchange, the company wants “the spread,” which means, for example, that they might keep the first 3.5% of annual growth, and the contract holder gets everything above this percentage. Alternately, they may request a ceiling provision, referred to as a cap, whereby during any calendar month where the index goes up more than a set percentage, then the company keeps the excess, or a percentage of the excess. The percentage of the excess is referred to as a participation rate. An example would be that the carrier keeps 80% of everything over 3% in gains per month and keeps 100% of the first 3%. One problem is that it is difficult for a layman, or even an expert, to understand how this mechanism works, and to appreciate how much money may be left on the table for the carrier based upon how index markets typically move.

It stands to reason that insurance carriers are not designing equity-index annuity products to lose money. The carriers have to be designing the products to enable them to earn a profit notwithstanding how the market indexes perform, so that they can pay the significant commissions and earn money somehow as a result of the “spread” between how the indexes perform and what portion of that performance is actually allocated to the cash value of the policy holders’ portfolios.

The definitions used to describe these arrangements also reveal how the carrier is keeping a significant portion of the growth from the index:

1. “Point to point measurement” - The increase for each year is based upon comparison of the value on the first day of the policy year to the value on the last day of the policy year, and therefore the highest value of the index is missed.

Typically all indexes go up and down during the year or a given month, so if the anniversary date of the policy is the referenced date, the policy holder is not getting the full growth of the index each year.

2. “The spread” - With a spread approach, the carrier keeps a certain percentage of growth for a particular period of time.

For example, a 2.5% annual spread means that if the index goes up by 8.5% from anniversary date to anniversary date, the contract only receives a 6% increase in value.

3. A “cap” or “ceiling” provision will indicate that any growth over a certain percentage for a certain period will go to the carrier.
4. “Participation Rate” – With this approach, the carrier will receive a percentage of any increase. If the participation rate is 80%, the contract holder will only get 80% of the index gain, leaving the company with the remaining 20%. For example with an 80% participation rate and a 9% increase in the index, the contract holder’s account will only be credited with 7.2% ( $9\% \times 80\% = 7.2\%$ ). Under this arrangement the contract holder can still be subject to one or more of the above carve-outs.

It is also worth noting that these arrangements are not fixed or guaranteed under the contract, and that illustrations can be confusing, if not deceptive. The majority of index annuity contracts reserve the right for the provider to alter the terms of sharing at any time, across the board. For example one annuity contract provided the authors with illustrations with a 1.90% per year spread, but reserved the right to increase this spread to up to 12%, which would dramatically change the illustrated values. Most investors will not be aware that the spread was increased, and surrender charges will not be waived in these situations, so the policy holder will be stuck.

These index contracts therefore are designed to provide the carriers with significant income, which the authors assume will, for most years, replicate or exceed the high normal percentage charges that investors pay, as evidenced by the commissions and surrender charges being of equal size to the income guarantee high-fixed annual cost products.

The implication is that since the commissions and surrender charges are the same, the carrier is expecting to make 3 % -- 3.5% or more a year on this product. This rate is highly dependent on assumptions used by the carrier in its illustrations, and actual market performance. This is consistent with spreadsheets that we have run based upon carrier disclosures, such as the illustrations found below.

## Hypothetical Values – Most Recent 25-year period

Here's how the [REDACTED] Annuity might look over a 25-year period. The values show what would happen if the indexed allocations earned indexed interest using current caps and/or spread, and the fixed allocation earned the current annual fixed rate in all years. The indexed interest is based on actual index performance during the most recent 25-year period.

Example: Hypothetical Values Over the Last 25 Years for a contract issued on 3/10/1989

Year Ending	Age	Net Premiums <sup>1</sup>	Credited Interest Rate <sup>2</sup>	Accumulation Value	Cash Surrender Value	Guaranteed Minimum Value <sup>3</sup>	PIV Credit <sup>4</sup>	Protected Income Value <sup>5</sup>	Beginning of Year Lifetime Income Withdrawal
3/10/1989	56	\$1,000,000							
3/9/1990	56-57	\$0	10.47%	\$1,104,662	\$994,196	\$886,813	15.70%	\$1,330,542	\$0
3/9/1991	57-58	\$0	9.70%	\$1,211,821	\$1,090,639	\$898,784	14.55%	\$1,524,147	\$0
3/9/1992	58-59	\$0	7.70%	\$1,305,119	\$1,190,921	\$910,918	11.55%	\$1,700,164	\$0
3/9/1993	59-60	\$0	8.78%	\$1,419,701	\$1,313,224	\$923,215	13.17%	\$1,924,062	\$0
3/9/1994	60-61	\$0	2.23%	\$1,451,345	\$1,360,636	\$935,679	3.34%	\$1,988,389	\$0
3/9/1995	61-62	\$0	0.53%	\$1,458,986	\$1,386,037	\$948,311	0.79%	\$2,004,093	\$0
3/9/1996	62-63	\$0	20.15%	\$1,752,927	\$1,687,192	\$961,113	30.22%	\$2,609,736	\$0
3/9/1997	63-64	\$0	12.28%	\$1,968,205	\$1,919,000	\$974,088	18.42%	\$3,090,493	\$0
3/9/1998	64-65	\$0	12.61%	\$2,216,317	\$2,188,613	\$987,238	18.91%	\$3,674,875	\$0
3/9/1999	65-66	\$0	5.74%	\$2,343,597	\$2,343,597	\$1,000,566	8.61%	\$3,991,439	\$0
3/9/2000	66-67	\$0	0.65%	\$2,177,948	\$2,177,948	\$829,160	0.97%	\$3,721,210	\$179,615
3/9/2001	67-68	\$0	2.44%	\$2,045,218	\$2,045,218	\$654,285	3.65%	\$3,535,969	\$181,354
3/9/2002	68-69	\$0	0.00%	\$1,857,240	\$1,857,240	\$470,970	0.00%	\$3,210,974	\$187,978
3/9/2003	69-70	\$0	0.00%	\$1,669,262	\$1,669,262	\$285,821	0.00%	\$2,885,979	\$187,978
3/9/2004	70-71	\$0	13.05%	\$1,674,659	\$1,674,659	\$98,821	19.58%	\$3,062,475	\$187,978
3/9/2005	71-72	\$0	0.00%	\$1,449,871	\$1,449,871	\$0	0.00%	\$2,651,401	\$224,788
3/9/2006	72-73	\$0	0.90%	\$1,236,154	\$1,236,154	\$0	1.36%	\$2,270,698	\$224,788
3/9/2007	73-74	\$0	6.96%	\$1,078,526	\$1,078,526	\$0	10.44%	\$2,045,630	\$227,835
3/9/2008	74-75	\$0	1.29%	\$837,544	\$837,544	\$0	1.93%	\$1,598,661	\$251,631
3/9/2009	75-76	\$0	0.00%	\$581,052	\$581,052	\$0	0.00%	\$1,109,083	\$256,492
3/9/2010	76-77	\$0	13.82%	\$369,403	\$369,403	\$0	20.72%	\$747,894	\$256,492
3/9/2011	77-78	\$0	8.55%	\$64,866	\$64,866	\$0	12.83%	\$136,501	\$309,648
3/9/2012	78-79	\$0	3.07%	\$0	\$0	\$0	4.60%	\$0	\$349,375
3/9/2013	79-80	\$0	4.44%	\$0	\$0	\$0	6.66%	\$0	\$365,437
3/9/2014	80-81	\$0	5.10%	\$0	\$0	\$0	7.65%	\$0	\$389,781
		\$1,000,000							\$3,781,170

<sup>1</sup> Represents premium paid minus withdrawal(s) for each Contract Year before Lifetime Income Withdrawals begin.

<sup>2</sup> Reflects the combined results of any indexed interest rates and/or annual fixed rate credited to Accumulation Value each Contract Year based on your selected allocation percentages.

<sup>3</sup> You would receive your Contract's Guaranteed Minimum Value only if it were higher than your Contract's Cash Surrender Value.

<sup>4</sup> Reflects the Credited Interest Rate plus the 150% Protected Income Interest Bonus Factor.

<sup>5</sup> Reflects any indexed interest rates and/or annual fixed rate, the 150% Protected Income Interest Bonus Factor and the 15% premium bonus.



## Hypothetical Values – Most Recent 10-calendar year period

Here's how the [REDACTED] Annuity might look over a 30-year period. The values show what would happen if the indexed allocations earned indexed interest using current caps and/or spread, and the fixed allocation earned the current annual fixed rate in all years. The indexed interest is based on actual index performance during the most recent 10-calendar year period for the first 10 years. In all later years, we repeat the index performance from the first 10-year period.

End of Contract Year	Age	Net Premiums <sup>1</sup>	Credited Interest Rate <sup>2</sup>	Accumulation Value	Cash Surrender Value	Guaranteed Minimum Value <sup>3</sup>	PIV Credit <sup>4</sup>	Protected Income Value <sup>5</sup>	Beginning of Year Lifetime Income Withdrawal
0	56	\$1,000,000							
1	56-57	\$0	3.12%	\$1,031,205	\$928,084	\$886,813	4.68%	\$1,203,828	\$0
2	57-58	\$0	0.00%	\$1,031,205	\$928,084	\$898,784	0.00%	\$1,203,828	\$0
3	58-59	\$0	9.16%	\$1,125,652	\$1,027,158	\$910,918	13.74%	\$1,369,216	\$0
4	59-60	\$0	2.17%	\$1,150,101	\$1,063,844	\$923,215	3.26%	\$1,413,824	\$0
5	60-61	\$0	0.00%	\$1,150,101	\$1,078,220	\$935,679	0.00%	\$1,413,824	\$0
6	61-62	\$0	8.10%	\$1,243,220	\$1,181,059	\$948,311	12.14%	\$1,585,531	\$0
7	62-63	\$0	7.22%	\$1,332,951	\$1,282,965	\$961,113	10.83%	\$1,757,187	\$0
8	63-64	\$0	2.25%	\$1,362,985	\$1,328,911	\$974,088	3.38%	\$1,816,577	\$0
9	64-65	\$0	4.23%	\$1,420,688	\$1,402,930	\$987,238	6.35%	\$1,931,937	\$0
10	65-66	\$0	8.88%	\$1,546,836	\$1,546,836	\$1,000,566	13.32%	\$2,189,251	\$0
11	66-67	\$0	3.12%	\$1,493,514	\$1,493,514	\$911,070	4.68%	\$2,145,766	\$98,516
12	67-68	\$0	0.00%	\$1,390,386	\$1,390,386	\$816,022	0.00%	\$1,997,600	\$103,128
13	68-69	\$0	9.16%	\$1,405,159	\$1,405,159	\$720,023	13.74%	\$2,103,519	\$103,128
14	69-70	\$0	2.17%	\$1,315,835	\$1,315,835	\$608,755	3.26%	\$1,990,738	\$117,296
15	70-71	\$0	0.00%	\$1,194,718	\$1,194,718	\$492,514	0.00%	\$1,807,499	\$121,117
16	71-72	\$0	8.10%	\$1,160,526	\$1,160,526	\$375,111	12.14%	\$1,821,524	\$121,117
17	72-73	\$0	7.22%	\$1,098,658	\$1,098,658	\$241,677	10.83%	\$1,782,460	\$135,827
18	73-74	\$0	2.25%	\$969,489	\$969,489	\$92,057	3.38%	\$1,590,227	\$150,532
19	74-75	\$0	4.23%	\$848,326	\$848,326	\$0	6.35%	\$1,419,744	\$155,620
20	75-76	\$0	8.88%	\$743,454	\$743,454	\$0	13.32%	\$1,294,967	\$165,502
21	76-77	\$0	3.12%	\$573,256	\$573,256	\$0	4.68%	\$1,013,619	\$187,545
22	77-78	\$0	0.00%	\$376,932	\$376,932	\$0	0.00%	\$666,484	\$196,324
23	78-79	\$0	9.16%	\$197,150	\$197,150	\$0	13.74%	\$363,222	\$196,324
24	79-80	\$0	2.17%	\$0	\$0	\$0	3.26%	\$0	\$223,295
25	80-81	\$0	0.00%	\$0	\$0	\$0	0.00%	\$0	\$230,570
26	81-82	\$0	8.10%	\$0	\$0	\$0	12.14%	\$0	\$230,570
27	82-83	\$0	7.22%	\$0	\$0	\$0	10.83%	\$0	\$258,573
28	83-84	\$0	2.25%	\$0	\$0	\$0	3.38%	\$0	\$286,567
29	84-85	\$0	4.23%	\$0	\$0	\$0	6.35%	\$0	\$296,252
30	85-86	\$0	8.88%	\$0	\$0	\$0	13.32%	\$0	\$315,066
		\$1,000,000							\$3,692,869

<sup>1</sup> Represents premium paid minus withdrawal(s) for each Contract Year before Lifetime Income Withdrawals begin.

<sup>2</sup> Reflects the combined results of any indexed interest rates and/or annual fixed rate credited to Accumulation Value each Contract Year based on your selected allocation percentages.

<sup>3</sup> You would receive your Contract's Guaranteed Minimum Value only if it were higher than your Contract's Cash Surrender Value.

<sup>4</sup> Reflects the Credited Interest Rate plus the 150% Protected Income Interest Bonus Factor.

<sup>5</sup> Reflects any indexed interest rates and/or annual fixed rate, the 150% Protected Income Interest Bonus Factor and the 15% premium bonus.

**Indexed Annuity Hypothetical Values  
Most Recent 10 Years Repeating  
Current Caps and Spreads  
Without Tax Considerations**

Indexed Annuity																			
Contract Year	Age	Purchase Price	Accumulation Value	Annual Index Increase (to 0% dividend)	Annual Index Increase (to 1.0% dividend)	Credited Interest Rate	% Increase Forfeited	Dollar Amount Forfeited or Given	Cumulative Amount Forfeited	Cumulative Amount Forfeited if Interest was Index	Cash Surrender Value	Guaranteed Minimum Value	Payment Base Premium Amount	Annual Income Withdrawals	Annual Rate of Return on Withdrawals	Death Benefit	Rate of Return of Death	Benefit of Heir at Death	
0	56	\$ 1,000,000																	
1	57	\$ 1,021,205		5.41%	6.38%	5.17%	0.04%	\$0,421	\$0,421	\$0,421	\$92,084	\$96,513	\$ 1,209,828			\$ 1,021,205	5.27%	0.19%	
2	58	\$ 1,042,812		5.41%	7.28%	5.00%	0.00%	\$0,000	\$0,000	\$0,000	\$176,719	\$186,784	\$ 1,329,828			\$ 1,042,812	5.58%	0.38%	
3	59	\$ 1,125,852		5.75%	10.52%	5.18%	1.12%	\$1,976	\$6,889	\$7,463	\$ 327,558	\$352,381	\$ 1,369,258			\$ 1,125,852	6.02%	0.60%	
4	60	\$ 1,316,101		6.08%	15.79%	5.17%	2.02%	\$3,945	\$6,330	\$16,893	\$ 613,864	\$653,154	\$ 1,516,101			\$ 1,316,101	6.58%	0.98%	
5	61	\$ 1,545,101		6.38%	22.02%	5.02%	1.88%	\$2,420	\$1,812	\$6,564	\$ 878,220	\$937,879	\$ 1,612,420			\$ 1,545,101	7.08%	1.37%	
6	62	\$ 1,819,220		6.67%	30.41%	5.11%	3.11%	\$11,966	\$11,966	\$18,789	\$ 1,193,689	\$1,268,511	\$ 1,819,220			\$ 1,819,220	7.50%	1.82%	
7	63	\$ 2,142,851		6.95%	42.02%	5.22%	4.83%	\$27,713	\$42,020	\$59,711	\$ 1,622,965	\$1,713,187	\$ 2,142,851			\$ 2,142,851	7.85%	2.41%	
8	64	\$ 2,522,851		7.21%	57.02%	5.29%	7.27%	\$71,818	\$171,818	\$257,758	\$ 2,128,811	\$2,248,588	\$ 2,522,851			\$ 2,522,851	8.15%	3.14%	
9	65	\$ 2,972,851		7.46%	75.79%	5.32%	10.24%	\$176,719	\$376,719	\$562,812	\$ 2,716,719	\$2,852,812	\$ 2,972,851			\$ 2,972,851	8.40%	3.98%	
10	66	\$ 3,502,851		7.69%	100.00%	5.34%	13.95%	\$376,719	\$776,719	\$1,112,812	\$ 3,002,851	\$3,152,812	\$ 3,502,851			\$ 3,502,851	8.61%	4.97%	
11	67	\$ 4,122,851		7.90%		5.35%	18.79%	\$676,719	\$1,452,812	\$2,088,812	\$ 3,382,851	\$3,542,812	\$ 4,122,851			\$ 4,122,851	8.79%	6.28%	
12	68	\$ 4,842,851		8.10%		5.36%	25.11%	\$1,176,719	\$2,628,812	\$3,744,812	\$ 3,712,851	\$3,882,812	\$ 4,842,851			\$ 4,842,851	8.94%	7.95%	
13	69	\$ 5,662,851		8.29%		5.37%	33.51%	\$1,976,719	\$4,604,812	\$6,580,812	\$ 4,002,851	\$4,182,812	\$ 5,662,851			\$ 5,662,851	9.07%	10.08%	
14	70	\$ 6,582,851		8.47%		5.38%	44.51%	\$3,176,719	\$7,780,812	\$11,956,812	\$ 4,202,851	\$4,392,812	\$ 6,582,851			\$ 6,582,851	9.18%	12.77%	
15	71	\$ 7,602,851		8.64%		5.39%	58.71%	\$4,776,719	\$12,556,812	\$19,532,812	\$ 4,302,851	\$4,502,812	\$ 7,602,851			\$ 7,602,851	9.28%	16.47%	
16	72	\$ 8,722,851		8.80%		5.40%	77.01%	\$6,776,719	\$19,332,812	\$29,108,812	\$ 4,402,851	\$4,612,812	\$ 8,722,851			\$ 8,722,851	9.37%	21.21%	
17	73	\$ 9,942,851		8.95%		5.41%	100.00%	\$9,942,851	\$29,280,812	\$48,228,812	\$ 4,502,851	\$4,722,812	\$ 9,942,851			\$ 9,942,851	9.45%	26.94%	
18	74	\$ 11,262,851		9.09%		5.42%		\$0,000	\$39,176,812	\$67,404,812	\$ 4,602,851	\$4,832,812	\$ 11,262,851			\$ 11,262,851	9.52%	34.04%	
19	75	\$ 12,682,851		9.22%		5.43%		\$0,000	\$50,000,812	\$87,404,812	\$ 4,702,851	\$4,942,812	\$ 12,682,851			\$ 12,682,851	9.58%	42.94%	
20	76	\$ 14,202,851		9.34%		5.44%		\$0,000	\$62,812,812	\$109,216,812	\$ 4,802,851	\$5,062,812	\$ 14,202,851			\$ 14,202,851	9.64%	53.94%	
21	77	\$ 15,822,851		9.45%		5.45%		\$0,000	\$77,624,812	\$134,040,812	\$ 4,902,851	\$5,172,812	\$ 15,822,851			\$ 15,822,851	9.69%	67.64%	
22	78	\$ 17,542,851		9.55%		5.46%		\$0,000	\$94,636,812	\$162,876,812	\$ 5,002,851	\$5,282,812	\$ 17,542,851			\$ 17,542,851	9.74%	84.64%	
23	79	\$ 19,362,851		9.64%		5.47%		\$0,000	\$114,048,812	\$195,724,812	\$ 5,102,851	\$5,392,812	\$ 19,362,851			\$ 19,362,851	9.78%	105.64%	
24	80	\$ 21,282,851		9.72%		5.48%		\$0,000	\$136,060,812	\$232,572,812	\$ 5,202,851	\$5,502,812	\$ 21,282,851			\$ 21,282,851	9.82%	131.64%	
25	81	\$ 23,302,851		9.79%		5.49%		\$0,000	\$160,072,812	\$273,420,812	\$ 5,302,851	\$5,612,812	\$ 23,302,851			\$ 23,302,851	9.85%	161.64%	
26	82	\$ 25,422,851		9.85%		5.50%		\$0,000	\$186,084,812	\$319,268,812	\$ 5,402,851	\$5,722,812	\$ 25,422,851			\$ 25,422,851	9.88%	206.64%	
27	83	\$ 27,642,851		9.90%		5.51%		\$0,000	\$214,096,812	\$370,116,812	\$ 5,502,851	\$5,832,812	\$ 27,642,851			\$ 27,642,851	9.91%	268.64%	
28	84	\$ 29,962,851		9.94%		5.52%		\$0,000	\$244,108,812	\$426,964,812	\$ 5,602,851	\$5,942,812	\$ 29,962,851			\$ 29,962,851	9.94%	349.64%	
29	85	\$ 32,382,851		9.97%		5.53%		\$0,000	\$276,120,812	\$490,812,812	\$ 5,702,851	\$6,052,812	\$ 32,382,851			\$ 32,382,851	9.97%	454.64%	
30	86	\$ 34,902,851		10.00%		5.54%		\$0,000	\$310,132,812	\$561,660,812	\$ 5,802,851	\$6,162,812	\$ 34,902,851			\$ 34,902,851	10.00%	596.64%	

Warning: This spreadsheet is an attempt by the authors to explain and demonstrate how this financial product works, but has not been verified as accurate by the center or any agency, agent, or other party, notwithstanding any and all requests that have been made. It may be subject to change without notice, and is not intended to be used as a substitute for professional advice.

**Indexed Annuity Hypothetical Values  
Most Recent 10 Years Repeating  
Current Caps and Spreads  
Without Tax Considerations**

Hypothetical Index Fund														Summary							
Contract Year	Age	Initial Outlay	Beginning Balance	Index Fund Rate of Return	Index Fund Dividend	Withdrawals	Commutative Withdrawals	Ending Balance	Dividend Paid (to 0% of Fund Return)	Annual Rate of Return	Index of Value over Annuity (Index x Dividend Annuity)	Benefit of Heir at Death	Contract Year	Age	Final Value of Annuity	Value of Hypothetical Index Fund Investment	Index of Value over Annuity (Index x Dividend Annuity)	Annual Rate of Return for Index Annuity Contract	Annual Rate of Return for Hypothetical Index Fund	Rate of Return of Heir at Death	Benefit of Heir at Death
0	56	\$ 1,000,000	\$ 1,000,000	5.41%	\$0,000			\$ 1,021,205	\$ 2,091.82	5.28%	20,977.74	0.19%	0	56	\$ 1,021,205	\$ 1,021,205	20,977.74	5.27%	0.19%	\$ 1,021,205	
1	57	\$ 1,042,812	\$ 1,042,812	5.75%	\$0,000			\$ 1,098,937	\$ 6,022.04	5.89%	48,153.77	0.38%	1	57	\$ 1,098,937	\$ 1,098,937	48,153.77	5.58%	0.38%	\$ 1,098,937	
2	58	\$ 1,125,852	\$ 1,125,852	6.08%	\$0,000			\$ 1,217,944	\$ 18,366.64	6.39%	118,880.80	0.60%	2	58	\$ 1,217,944	\$ 1,217,944	118,880.80	6.02%	0.60%	\$ 1,217,944	
3	59	\$ 1,316,101	\$ 1,316,101	6.38%	\$0,000			\$ 1,517,268	\$ 53,148.48	6.79%	343,544.34	0.98%	3	59	\$ 1,517,268	\$ 1,517,268	343,544.34	6.58%	0.98%	\$ 1,517,268	
4	60	\$ 1,545,101	\$ 1,545,101	6.67%	\$0,000			\$ 1,819,220	\$ 127,626.00	7.22%	842,368.88	1.37%	4	60	\$ 1,819,220	\$ 1,819,220	842,368.88	7.08%	1.37%	\$ 1,819,220	
5	61	\$ 1,819,220	\$ 1,819,220	6.95%	\$0,000			\$ 2,142,851	\$ 277,626.00	7.69%	1,620,604.88	1.82%	5	61	\$ 2,142,851	\$ 2,142,851	1,620,604.88	7.50%	1.82%	\$ 2,142,851	
6	62	\$ 2,142,851	\$ 2,142,851	7.21%	\$0,000			\$ 2,522,851	\$ 547,626.00	8.15%	2,408,230.88	2.41%	6	62	\$ 2,522,851	\$ 2,522,851	2,408,230.88	7.85%	2.41%	\$ 2,522,851	
7	63	\$ 2,522,851	\$ 2,522,851	7.46%	\$0,000			\$ 2,972,851	\$ 1,017,626.00	8.40%	3,425,856.88	3.14%	7	63	\$ 2,972,851	\$ 2,972,851	3,425,856.88	8.15%	3.14%	\$ 2,972,851	
8	64	\$ 2,972,851	\$ 2,972,851	7.69%	\$0,000			\$ 3,502,851	\$ 1,977,626.00	8.61%	4,603,482.88	3.98%	8	64	\$ 3,502,851	\$ 3,502,851	4,603,482.88	8.40%	3.98%	\$ 3,502,851	
9	65	\$ 3,502,851	\$ 3,502,851	7.90%	\$0,000			\$ 4,122,851	\$ 3,477,626.00	8.79%	6,081,008.88	4.97%	9	65	\$ 4,122,851	\$ 4,122,851	6,081,008.88	8.61%	4.97%	\$ 4,122,851	
10	66	\$ 4,122,851	\$ 4,122,851	8.10%	\$0,000			\$ 4,842,851	\$ 7,447,626.00	8.94%	7,828,634.88	6.28%	10	66	\$ 4,842,851	\$ 4,842,851	7,828,634.88	8.94%	6.28%	\$ 4,842,851	
11	67	\$ 4,842,851	\$ 4,842,851	8.29%	\$0,000			\$ 5,662,851	\$ 13,817,626.00	9.07%	10,454,260.88	7.95%	11	67	\$ 5,662,851	\$ 5,662,851	10,454,260.88	9.07%	7.95%	\$ 5,662,851	
12	68	\$ 5,662,851	\$ 5,662,851	8.47%	\$0,000			\$ 6,582,851	\$ 24,817,626.00	9.18%	14,280,886.88	10.08%	12	68	\$ 6,582,851	\$ 6,582,851	14,280,886.88	9.18%	10.08%	\$ 6,582,851	
13	69	\$ 6,582,851	\$ 6,582,851	8.64%	\$0,000			\$ 7,602,851	\$ 40,817,626.00	9.28%	18,506,512.88	12.77%	13	69	\$ 7,602,851	\$ 7,602,851	18,506,512.88	9.28%	12.77%	\$ 7,602,851	
14	70	\$ 7,602,851	\$ 7,602,851	8.80%	\$0,000			\$ 8,722,851	\$ 62,817,626.00	9.37%	23,732,138.88	16.47%	14	70	\$ 8,722,851	\$ 8,722,851	23,732,138.88	9.37%	16.47%	\$ 8,722,851	
15	71	\$ 8,722,851	\$ 8,722,851	8.95%	\$0,000			\$ 9,942,851	\$ 90,817,626.00	9.45%	30,357,764.88	21.21%	15	71	\$ 9,942,851	\$ 9,942,851	30,357,764.88	9.45%	21.21%	\$ 9,942,851	
16	72	\$ 9,942,851	\$ 9,942,851	9.09%	\$0,000			\$ 11,262,851	\$ 126,817,626.00	9.52%	38,383,390.88	26.94%	16	72	\$ 11,262,851	\$ 11,262,851	38,383,390.88	9.52%	26.94%	\$ 11,262,851	
17	73	\$ 11,262,851	\$ 11,262,851	9.22%	\$0,000			\$ 12,682,851	\$ 172,817,626.00	9.58%	48,008,916.88	34.04%	17	73	\$ 12,682,851	\$ 12,682,851	48,008,916.88	9.58%	34.04%	\$ 12,682,851	
18	74	\$ 12,682,851	\$ 12,682,851	9.34%	\$0,000			\$ 14,202,851	\$ 238,817,626.00	9.64%	59,634,442.88	42.94%	18	74	\$ 14,202,851	\$ 14,202,851	59,634,442				

phantom account is “guaranteed” to grow, so that the minimum annual payments will not be as high as the policy owner expects. The authors have reviewed a number of these policies, and have found that the phantom account will never come close to providing the stated rate of return, notwithstanding that the policy owner may receive statements that lead him or her to believe that the phantom account would yield income based upon the stated interest rate.

Since the carrier already has made and charged for assurances that the actual account will not go down in value, it is difficult to fathom how the carrier can charge an additional percentage of the “roll up” phantom account per year for this “additional feature”, but they do.

Oftentimes the contracts also have “guaranteed death benefits” that generally assure that an amount equal to the total investments in the contract minus withdrawals will be paid (if the cash value is lower than this) on the death of the contract holder.

Usually these “guaranteed death benefits” only last until a specified age, such as 85, and disappear if and when the contract holder ever has to annuitize in order to receive the minimum payments.

### **“The Doubler”**

Many carriers offering “guaranteed income” features that work without the requirement of permanent annuitization also provide that the minimum payments will be doubled during any time that the policy holder becomes incapacitated, as evidenced by not being able to perform two of the six Activities of Daily Living (ADL’s) that also apply for Medicaid eligibility purposes to determine whether an individual qualifies for nursing home benefits. The Six Activities of Daily Living are (1) eating; (2) bathing; (3) dressing; (4) toileting; (5) transferring (walking); and (6) continence.

The “doubler” is a feature that makes the guaranteed minimum payments twice as much as they would otherwise be if the policyholder does not have the ability to perform two of the six above activities, but typically the policyholder believes this is extra money being put on the table by the insurance company. In reality, the insurance company only puts extra money on the table if and when the contract completely runs out.

A similar product is a cash-rich life insurance policy that provides that the death benefit would be available to pay for long-term care, based upon the same two out of six needs criteria.

Obviously, the life insurance company is taking the risk of putting up the death benefit into account in pricing the policy, and also limits its exposure by allowing only a certain amount to be paid out each month, over a stated term of years. Typically someone who has two or more of the six needs also has a significantly diminished life expectancy, so from a statistical standpoint, the life insurance carrier is taking on much less risk than if the cash value were available to pay all of the applicable expenses, instead of the limited monthly amount.

The client opted not to purchase any nursing home insurance, after being shown traditional nursing home policies, a “guaranteed annuity with doubler”, and the below life insurance alternative.



## **CHAPTER 10**

### **CHARITABLE ANNUITY PLANNING**

Internal Revenue Code Section 170 provides an income tax deduction for charitable contributions. Contributions to a public charity can offset ordinary income to the extent of 50% of an individual donor's taxable income, and can be carried forward to the extent not used in a particular year.

In this outline we refer to "charitable annuity transactions" as the exchange of money and/or other property between a donor and a charitable organization.

When an economic benefit is received as partial consideration for a charitable gift, the income tax deduction is limited to the excess of the amount donated over the economic benefit received.

The 50% adjusted gross income limitation for the income tax charitable deduction is reduced to 20% and 30% for private non-operating foundations.

A charitable gift annuity is normally structured as a contractual obligation to pay a fixed annual or more frequent amount for a term of years, or for the lifetime of one or more "annuitants." Typically the obligation is not secured by any assets, and the payee is considered to be a general creditor of the charitable organization. If the charity becomes insolvent, then the donor/payee may not receive further payments. Many states have regulations that govern the structuring of charitable annuities. Ohio has no such statutes.

Charitable gift annuities essentially work just like fixed annuities, except that what you give the charity is about twice as much as you would give to a commercial carrier for the same payment back. The charity cannot give you collateral or any security. It is an unsecured promise that the organization is going to make these payments to you. There are certain requirements that have to be met for a charity to be able to avoid the unrelated business taxable income rules.

Charitable gift annuities are immediate or deferred fixed (pre-set annual or more frequent dollar amount payment) contracts entered into between a donor and a charity.

The rule of thumb is that the charity will normally pay the donor payments of approximately 50% (or as high as 90%) of what a commercial annuity contract would be expected to pay, and the donor will receive an income tax deduction equal to the excess of the amounts paid to the carrier over what an annuity from a commercial carrier would cost.

So you could give a charity \$1,000,000 for an annuity that would pay you approximately \$27,013 a year for life, and receive a tax deduction of approximately \$500,000, which could save approximately \$217,000 in taxes (assuming the maximum tax rate of 43.4% for a Floridian). The other \$500,000 of cost would be allocated among the payments in the same way as would apply for a normal commercial annuity contract.

Certain rules must be followed to permit the charitable organization to avoid having to report the income that it derives from assets that have been received from charitable annuity donors under the unrelated business taxable income rules. Otherwise, a charitable organization that invests monies borrowed has to pay income on earnings from the borrowing.

The requirements that must be met are as follows:

- (a) The determined value of the annuity right at the time of inception is less than 90% of the monies and/or the value of any other property received by the charity in the exchange.
- (b) The annuity must be payable over the lifetime of one or two individuals who are living at the time of the exception.
- (c) The annuity cannot guarantee a minimum number of payments or a maximum number of payments.
- (d) The annuity payments cannot vary by reference to the income or operating results from any assets received in the exchange.

Charities that will not have income derived from the monies received in the annuity transaction do not need to follow the above rules, even though the charity may have income from investments that were not received in charitable annuity transactions.

If the unrelated business taxable income exception above does not need to be met, then it is possible to have the annuity payments be for a set term, and to have a minimum term of payments as well.

The American Council on Gift Annuities publishes an industry standard rate table that can be obtained at [www.acga-web.org](http://www.acga-web.org). The rates published by the Council are intended to be based upon having the annuity contract obligation being worth 50% of the donation amount. Charities are free, however, to provide a higher amount.

The Philanthropy Protection Act of 1995 and the Charitable Gift Annuity AntiTrust Relief Act of 1995 exempt charitable organizations from anti-trust scrutiny for using agreed upon industry-recommended rates, and from having to comply with federal and state securities laws.

To determine how much of each annuity payment will be income and how much will be excluded from income under the “investment in the contract” basis rules, the “exclusion ratio” percentage is multiplied by the amount of each payment to determine how much of the payment is exempt from federal income tax. This ratio is based upon the value of the annuity at the time of the annuity transaction divided by the expected return on the annuity. The expected return on the annuity is determined by reference to Table B of Treasury Reg. Section 1.72-9, as opposed to being based upon what a willing buyer would pay a willing seller after considering the health of people whose life expectancies are used.

An example provided in the Bloomberg BNA Tax Management Portfolio 863-2nd, Charitable Contributions: Income Tax Aspects indicates that if a 75-year old taxpayer purchased a charitable gift annuity from a public charity in 2007 in exchange for a promise by the church to pay \$5,000 a year for his lifetime, the present value of the annuity under the tables would be \$39,364, so the taxpayer would receive a \$60,636 tax deduction, and the exclusion ratio would be 62.982% (based upon \$39,364 divided by the expected gross payments, which are \$62,500. This \$62,500 is determined by taking the table life expectancy of a male taxpayer aged 75, which is 12.5 and multiplying this by \$5,000, which is the per year payment.<sup>45</sup>

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<sup>45</sup> Barbara L. Kirschten Esq., Wilmer Cutler Pickering Hale and Dorr LLP, and Carla Neeley Freitag, “Charitable Contributions: Income Tax Aspects,” 863-2nd Tax Mgmt. (BNA) Estates, Gifts, and Trusts, at A-61-62 (Aug. 13, 2012)

The taxpayer would therefore have taxable income of \$4,370 per year. Therefore, for the first 12.5 years the taxpayer would report \$1,851 of each \$5,000 payment as ordinary income, and \$2,519 as long-term capital gain. \$630 would be excluded as a return of investment. After the first 12.5 years, the taxpayer will have made full use of the exclusion ratio and all payments would be fully included in the taxpayer's gross income for income tax calculation purposes.

If the taxpayer dies before the 12.5 years has run, then the taxpayer would not have made full use of the exclusion ratio and the annuity payments cease; however, the unrecovered return on investment would be allowed as a deduction in the taxpayer's last taxable year.<sup>46</sup> If the taxpayer provided for the annuity payments to be made to a beneficiary, then the exclusion ratio would apply as described above.<sup>47</sup>

The donor of a charitable gift annuity receives a tax deduction in the year of the charitable annuity transaction based upon the amount of cash, and the fair market value of any other assets given to the charity over the present value of the annuity contract.

For annuities purchased after April 30, 1989, the value of an annuity purchased is determined in accordance with Internal Revenue Code Section 7520 tables. The IRS has authority to provide computation of the value of an annuity upon request. The request must specify the date of birth of each annuitant, and copies of all relevant documents.

The mortality tables used for this calculation were changed on May 1, 1999, and the tables can be found in IRS Publication 1457, entitled "Actuarial Values, Book Aleph."

The tables are revised every 10 years - April 30, 2009 tables now in place are found in IRS Publication 1457 "Actuarial Valuations Version 3A," which is available at no charge electronically at the IRS website. <http://www.irs.gov/pub/irs-pdf/p1457.pdf>.

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46 26 U.S.C. Section 72(b)(3)(A)

47 26 U.S.C. Section 72(c)(2)

## **CHAPTER 11**

### **QUALIFIED LONGEVITY ANNUITY CONTRACTS**

The following is the author's write-up on qualified longevity annuity contracts that appeared in the Leimberg Information Services system on August 20, 2014, with the rebuttal and corrective notations appropriately provided by insurance consultant Richard Connolly of Columbus, Ohio, in September of 2014.

After the article, we have an excellent analysis and commentary by insurance agent and consultant Richard Connolly of Ward and Connolly in Columbus, Ohio. His email address is rconnolly@wchins.net. Following this we have an article on QLAC's written by Michael Kitces. His email address is michael@kitces.com. If you have any complicated questions on QLACs, please ask Richard or Michael!

#### **A PRACTICAL APPROACH TO QUALIFYING LONGEVITY ANNUITY CONTRACTS (QLACS) - USING THE (KING) L.E.A.R. (LIFE EXPECTANCY AND RETURN) ANALYSIS TO DETERMINE WHETHER CLIENTS SHOULD INVEST IN SPECIALLY DESIGNED ANNUITY PRODUCTS UNDER THEIR IRA OR QUALIFIED RETIREMENT PLANS**

##### **EXECUTIVE SUMMARY:**

The insurance industry received a July 4<sup>th</sup> gift from the Internal Revenue Service in the form of a Final Regulations released on July 1, 2014 which make it possible to place a portion of IRA and retirement plan investments into fixed annuities called "Qualified Longevity Annuity Contracts" (QLACs) that will enable the IRA holder or plan participant to avoid the required minimum distribution rules that apply after age 70½ to the extent that IRA or plan assets are held under such vehicles. The maximum amount that can be contributed into such fixed annuities under an IRA or pension will be the lesser of \$125,000 or 25% of the value of the IRA or retirement plan account as of the time of the investment. The \$125,000 limitation applies cumulatively to all IRAs and retirement accounts that the taxpayer has, and the 25% limitation applies cumulatively to the account balance of all of such IRAs and retirement accounts.

Essentially, the value of such contracts will not be considered to be assets of the IRA or retirement plan for purposes of the required minimum distribution rules until the owner is age 85. The authors have developed the L.E.A.R. (Life Expectancy And Return) analysis spreadsheets to enable planners to determine if and when QLACs will be worthwhile for their clients. The main factor is the expected life expectancy of the account holder and their surviving spouse.

The basic QLAC requirements are that the annuity contract must state that it will pay fixed dollar amounts at stated intervals over a number of years for the life of a taxpayer, beginning no later than when the taxpayer attains the age of 85. These payments distributed from the QLAC are fully taxable, and will not count towards the individual's required minimum distribution obligations relating to non-QLAC retirement plan assets.

If the taxpayer dies before he or she has received payments equal to the amount paid for the contract, the contract may offer a return of premium option, but this option

is not required by the Regulations. The return of premium amount can be paid to the beneficiary's IRA or retirement account, but no more than the premium amount can be paid under this option. Thus, if the taxpayer dies before he or she has received more than his or her investment back there is, at best, a zero rate of return.

On the other hand, if the taxpayer or his or her designated beneficiaries have a life payment contract, and outlive their applicable life expectancy, then the rate of return on the contract can be positive, and they can be assured of "never running out of money." However, inflation and taxes may cause the real value of the payments to be lower than one might expect. Wealthy clients with long life expectancies may therefore be well suited to purchase \$125,000 in QLACs for their IRA or retirement plans.

#### **FACTS:**

The applicable Final QLAC Treasury Regulations at Sections 1.401(a)(9)-5, Q & A-3, 1.401(a)(9)-6, Q & A-12, 1.401(a)(9)-6 Q & A-17, 1.403(b)-6(e)(9) and 1.408-8, Q & A-12 allow QLACs to be held under non-Roth IRAs, defined contribution plans, and Section 403(b), and 457(b) plans, but not under defined benefit plans or Roth IRAs[i]. These Final Regulations replace Proposed Regulations that were issued in 2012 to allow commentary on this concept. The Final Regulations are substantially similar to the 2012 Proposed Regulations, with minor changes that are noteworthy as to policy and application.

According to the Final Regulations, QLACs may not be variable or equity indexed annuities, even if they offer a guaranteed minimum rate of return, unless or until explicitly approved by the Internal Revenue Service. Instead, QLACs must be annuity contracts with a fixed rate of return, life payment, or other similar features. The preamble to the new Regulations point out that variable and equity indexed annuities with contractual guarantees provide an unpredictable level of income to the holder and are therefore inconsistent with the purpose of the new Regulations. It is interesting that hybrid index annuity sales literature often touts protection of principal and reliable rates of return. The drafters of the new Regulations seem to disagree with these assertions.

#### **QLAC Math: Donald Duck in Mathematics Land?**

The premiums paid for a QLAC cannot exceed the lesser of \$125,000 or 25% of the IRA or pension account balance as of the last valuation date preceding the date of a premium payment. This is increased for post-valuation date contributions added to the account and decreased for post-valuation date distributions made from the account. The QLAC's value is excluded from the account balance that is used to calculate the annual required minimum distributions. However, the value of the QLAC is included for applying the 25% limit. The IRS kept the dollar and percentage limit to "constrain undue deferral of distribution of an employee's interest." [ii]

Next Calendar Year Correction Right - The Proposed Regulations stated that if the above premium limits were exceeded, then the contract would fail to be a QLAC. Fortunately, the Final Regulations provide that the contract will not fail to be a QLAC if any such excess portion is returned to the taxpayer's non-QLAC portion of his or her retirement plan or IRA by the end of the calendar year following the calendar year in which the excess premium was paid. This excess can be returned to the account in cash or in the form of an annuity contract that is not intended to be a QLAC. If at any time the QLAC or intended QLAC contract fails for reasons other than exceeding premium

limits, the contract will not be treated as a QLAC from the date of the first premium payment.

Inflation Adjustments to \$125,000 Amount in \$10,000 Increments – The \$125,000 dollar amount limitation described above will be adjusted for inflation in the same time and manner as under section 415(d) except: (1) The base period will be the quarter beginning six months before the effective date of the Regulation (the effective date of the Regulations is July 2, 2014, so the quarter beginning six months before the effective date appears to be January 1, 2014); and (2) any increase must exceed \$10,000 to apply for a given year. The 2012 Proposed Regulations had provided for a \$25,000 multiple to apply.

QLAC Payment Deferral Can Only Last Until Age 85, or Possibly Later if Mortality Tables Change - The annuity contract must provide for distributions to be made no later than a specific annuity starting date. This date cannot be later than the first day of the month following the taxpayer attaining age of 85. A taxpayer can elect to have an earlier annuity starting date, but the contract is not required to have an option to start distributions before the annuity starting date. The maximum age may be adjusted based on changes in mortality, although in Bulletin 2014-30, the IRS stated that it believes that these changes will not occur more often than the dollar limit adjustment.

Must be a Fixed Annuity - A variable contract under Internal Revenue Code Section 817, an indexed contract or, a similar contract will not qualify as a QLAC but the Commissioner may create an exception to this rule. However, a participating annuity contract is not similar to a variable contract or indexed contract just because it has payments of dividends as described in Treasury Regulation Section 1.401(a)(9)-6, A-14(c)(3). The Regulation also noted that a contract that has a cost-of-living adjustment discussed in Section 1.401(a)(9)-6, A-14(b), is not considered similar to a variable or indexed contract.

Illiquidity Required - A QLAC cannot make available any commutation benefit, cash surrender value, or other similar feature. In other words, the money invested in the QLAC is illiquid and irrevocable, which is an important factor to consider before a taxpayer invests in a QLAC. According to Bulletin 2014-30, this prohibition is in place because this “feature would significantly reduce the benefit of mortality pooling under the contracts.”<sup>[iii]</sup>

### **Death Benefits of a QLAC**

A QLAC may offer a return of premium after the death of the account holder that can be paid before or after the annuity starting date to the extent that the contract has not provided a return of the aggregate premium amount paid for the QLAC<sup>[iv]</sup>. The return of premium can be in place of a life annuity provided to a surviving spouse or designated beneficiary. A return of premium payment must be paid in a single lump sum to the beneficiary of the QLAC before the end of the year following the year of the account holder’s or surviving spouse’s death, as applicable.

If the applicable death occurs on or before the required annuitization date for the account holder or his or her surviving spouse (no later than age 85), then the return of premium is considered as the balance of the retirement plan or IRA account value that can be rolled over by the surviving spouse into his or her own IRA, or can be transferred into an inherited IRA for the benefit of the non-spouse beneficiary. However, if the

applicable death occurs after the required annuitization date then the return of premium is seen as a required minimum distribution for the year in which it is paid. The return of premium must be paid out to the account beneficiary when received from the carrier, and is fully taxable and cannot be rolled over into another qualified retirement plan.

If the only beneficiary of the QLAC is the account holder's surviving spouse, and the account holder's death occurs on or after the annuity start date, then the only benefit allowed to be paid (other than a return of premium) is a life annuity that cannot exceed 100% of the annuity payment payable to the account holder.[v] There is a special exception that allows a QLAC to provide a qualified preretirement survivor annuity defined in Internal Revenue Code Section 417(c)(2) in order to compensate the surviving spouse for the loss of retirement benefits that would have otherwise been paid to the deceased employee.

If there are multiple beneficiaries where one of which is the surviving spouse, then the QLAC can be treated as if there were a separate QLAC for each beneficiary so that the special rules applicable only to the surviving spouse would apply. This is only allowed if certain rules are satisfied.[vi] If the account holder's death occurs before the annuity starting date, the only benefit payable (other than a return of premium as described above) is a life annuity where the periodic annuity payment is not more than 100% of the annuity payment that would have been available to the account holder.[vii] However, it may exceed 100% if necessary to satisfy the requirements for a qualified preretirement survivor annuity.

If the surviving spouse is not the only beneficiary, and the account holder's death occurs on or after the annuity starting date, then the only benefit to be paid (other than a return of premium) is a life annuity payable to a beneficiary.[viii] The life annuity is not allowed to exceed an applicable percentage of the annuity payment payable to the employee under Treasury Regulation Section 1.401(a)(9)-6 A-17(c)(2)(iii).[ix] The percentage is provided in one of the two tables listed in the Section. Determining which table applies depends on the different types of death benefits that can be paid to the beneficiary under the contract.

The first table described in A-2(c) of Treasury Regulation Section 1.401(a)(9)-6[x] provides the applicable percentage distribution that must be made to the non-spouse beneficiary after the account holder's death, and this table may only be used if the contract provides that if the account holder dies before the annuity start date, then no death benefits are payable to a non-spouse beneficiary. However, if the account holder dies on or after his or her annuity start date, then the non-spouse beneficiary can receive a life annuity based on the above-referenced table.

Additionally, this table is available only if no benefits are payable under the contract where the taxpayer selects an earlier annuity starting date than the specified starting date under the contract, and dies less than 90 days after making that election. This second part of the requirement is to avoid taxpayers with shortened life expectancies from circumventing the first part of the rule.

The second table is described in Treasury Regulation Section 1.401(a)(9)-6 A-17(c)(2)(iii)(D).[xi] This table is used where the contract provides a pre-annuity start date death benefit to a non-spouse beneficiary. Under the 2012 Proposed QLAC Regulations, the use of this table was limited to contracts that only allowed non-spouse beneficiaries to be irrevocably selected as of the annuity start date. However, the Final

QLAC Regulations changed this rule to allow non-spouse beneficiaries to be selected at a different time in certain situations.

It is important to note that there is no violation of this irrevocability requirement when an account holder substitutes his or her spouse as the beneficiary. If the account holder's spouse is not the only beneficiary, and the account holder's death occurs before the annuity starting date, then the only payment available (other than a return of premium) is a life annuity where the payment is not more than the applicable percentage, under 1.401(a)(9)-6, A-17(c)(2)(iii), of the amount that would have been payable to the account holder.

### **Other QLAC Requirements**

When the QLAC is issued, the taxpayer must be notified that it is intended to be a QLAC. This is to make sure the issuer, taxpayer, plan sponsor, and IRS all know that the QLAC rules apply to this contract. This requirement is satisfied if this language is in the contract, or in a rider or endorsement to the contract. It can also be satisfied if a certificate is issued under a group annuity contract, and the certificate states that the taxpayer's interest is to be a QLAC.

In order to avoid surrender charges on current contracts that do not qualify as QLACs because of inadequate notice, there is a transition rule where any annuity contract dated before January 1, 2016 will not fail due to the notification requirement as long as the taxpayer is notified that the contract is intended to be a QLAC and is amended (or a rider, amendment to the certificate, or endorsement to the contract is issued) no later than December 31, 2016 to indicate that the contract is intended to be a QLAC.

Distributions must satisfy the requirements of Internal Revenue Code Section 401(a)(9) dealing with annuities in Treasury Regulation Section 1.401(a)(9)-6, except for the requirement that annuity payments commence on or before the taxpayer's beginning date.

### **Section 403(b) Plans and Section 457(b) Plans**

The Final Regulations apply the QLAC qualified plan rules when a QLAC is purchased under an eligible Section 403(b) or Section 457(b) plan, rather than the rules applicable to IRAs, which are described below.

### **IRAs**

The QLAC rules that apply to IRAs are significantly similar to the QLAC rules that apply to defined contribution retirement plans and Section 403(b) or 457(b) plans, as described above, with a few minor differences.

As applicable to defined contribution retirement plans and Section 403(b) or 457(b) plans, the amount of premiums paid for the contract under an IRA cannot exceed the lesser of 25% of the IRA account balance or \$125,000 in order to be a QLAC. This limit is reduced by the amount of premium payments made for the same contract or any other contract that was meant to be a QLAC under the IRA or any IRA, plan, or annuity.

However, the Final Regulations allow a QLAC that may be bought under an



IRA within these premium limits to be purchased under another, separate IRA. Thus, the amount of the premium paid cannot be more than the lesser of 25% of the aggregate account balance of all of such accounts or \$125,000. This limit is reduced by the amount of premium payments made for the same contract or any other contract that was meant to be a QLAC under the IRA or any IRA, plan, or annuity. The Regulations also state that the trustee, custodian, or issuer of the IRA may rely on the IRA owner's information on the amount of premiums for the dollar and percentage limits, and the amount of the IRA account balances for the purposes of the percentage limits, unless the trustee, custodian, or issuer of the IRA has knowledge to the contrary.

Since Roth IRAs are only subject to the minimum distribution rules after the death of the owner, an annuity bought under a Roth IRA is not treated as a QLAC. If a QLAC was purchased under a non-Roth IRA and that IRA is later converted or rolled over to a Roth IRA, then the QLAC would cease being a QLAC at the time of the conversion.

### **IRA QLACs Better for Men, Non-IRA QLACs Better for Women**

One important consideration is that QLACs purchased under an IRA must use gender-distinct life expectancy tables to determine the premium or monthly payout, and QLACs purchased under a non-IRA retirement plan must use gender-neutral life expectancy tables. This means that if a male taxpayer was faced with the alternative of purchasing the same QLAC under an IRA or under a non-IRA retirement plan, the IRA would result in a higher payout due to a shorter life expectancy being applicable to males versus the life expectancy that would apply under the gender-neutral tables.

In comparison, if a female taxpayer purchased the same QLAC under an IRA or a non-IRA retirement plan, then the non-IRA retirement plan would result in a higher payout because the female-specific life expectancy tables reflect a longer life expectancy than the gender-neutral tables. For example a 72 year old woman might have a 17.32 year life expectancy under the IRA gender-distinct tables, and a 15.59 year life expectancy (as does a man) under the gender-neutral tables that are applicable to non-IRA retirement plans. A 72 year old man might have a 14.26 year life expectancy under then IRA gender-distinct tables.

### **Defined Benefit Plans**

The QLAC Regulations do not allow for the changed minimum payout rules to apply for defined benefit pension plans. Many defined benefit plans can be converted in to rollover IRAs and can then purchase QLAC contracts.

### **Initial Disclosure and Annual Reporting Requirements**

The Final Regulations do not call for an initial disclosure requirement specifically applicable to QLACs because of the disclosure practices that are in place for qualified retirement plans under state law and Title I of ERISA. The Proposed Regulations had disclosure requirements that are fortunately not required by the Final Regulations.

There are pension plan annual reporting requirements under Internal Revenue Code Section 6047(d) that require annual reports to be filed with the IRS and a statement be given to the employee with the status of the contract. The report must contain, at a minimum, the following:

- The name, address, and identifying number of the issuer of the contract, along with information on how to contact the issuer for more information about the contract;
- The name, address, and identifying number of the individual in whose name the contract has been purchased;
- If the contract was purchased under a plan, the name of the plan, the plan number, and the Employer Identification Number (EIN) of the plan sponsor;
- If payments have not yet commenced, the annuity starting date on which the annuity is scheduled to commence, the amount of the periodic annuity payable on that date, and whether that date may be accelerated;
- For the calendar year, the amount of each premium paid for the contract and the date of the premium payment;
- The total amount of all premiums paid for the contract through the end of the calendar year; and
- The fair market value of the QLAC as of the close of the calendar year.

The issuer of the QLAC is also required to furnish to the taxpayer a statement with this information on or before January 31 following the year the report is required. These reports must be given each year starting with the year premiums are paid, and ending when the taxpayer attains the age of 85 or dies. If the sole beneficiary of the QLAC is the spouse and the taxpayer dies, the reporting requirement continues until the earlier of the year when distributions to the surviving spouse begin or the year in which the surviving spouse dies.

#### **Effective/Applicability Dates**

These Regulations became effective July 2, 2014. If an existing contract is traded for a contract that meets the QLAC requirements on or after this date, then the new contract may qualify as a QLAC and will be treated as obtained on the date of the exchange. In this situation, the fair market value of the original contract will act as the premium that counts towards the QLAC premium limit.

#### **COMMENT:**

QLACs offer taxpayers the opportunity to defer income taxes that would otherwise result from the larger required minimum distributions that would apply if a portion of the taxpayer's IRA or other retirement plan were not used to purchase a QLAC. However, the widespread prevalence of QLACs in the marketplace might not occur for some time, as the authors are not aware of any life insurance or annuity companies having released their QLAC products as of the time of this writing. In any event, the choice of investing in a QLAC turns on several factors, the most significant of which are whether the taxpayer wants fixed income features in the portfolio and whether the taxpayer will live long enough to realize a positive rate of return. Therefore, it is important to run an appropriate analysis, such as the L.E.A.R. analysis, to take into

account the taxpayer's life expectancy and possible rates of return on the investment in the QLAC.

Under a typical QLAC arrangement, a taxpayer could invest \$125,000 (the maximum amount that can be invested is the lesser of (1) 25% of the value of the qualified account at the time of the investment; or (2) \$125,000) into a deferred income annuity contract that would pay-out monthly income at an elected age (not to exceed 85) to the taxpayer.

One very knowledgeable advisor, **Michael Morrissey** of **Vanguard's** annuity division gave the authors the following example of how a hypothetical QLAC might perform:

A 65 year-old male who wants to receive a monthly income of \$1,000 per month for life beginning at age 80 can pay \$47,920 for a life annuity right now. The annuity contract would include not only the above payments, but also a refund on death to the extent that the total payments received before death did not amount to \$47,920. The value of this contract would not be subject to the required minimum distribution rules until the gentleman reaches age 80.

The new Regulations require that payments from a QLAC must begin to be made by age 85. A 65 year-old male who wants to receive \$1,000 a month for life beginning at age 85 would only have to pay \$26,634 for a Vanguard life annuity contract, which would also provide a refund to the extent that total payments are less than \$26,634 upon death.

In both of the above arrangements there is a death benefit feature, which provides that if the account holder dies before receiving payments equal to the amount invested, then the deficit amount will be paid to the account holder's beneficiaries (typically without interest) shortly after his or her death. In the alternative, payments might continue for the lifetime of a surviving spouse who could roll the annuity over to his or her own IRA and continue to have the benefit of payment rights. If the account holder dies before the elected age to begin distributions, the new Regulations allow a contract to return only the principal amount invested.

The death benefit restrictions are a major drawback of the new Regulations. These restrictions essentially require an account holder to outlive his or her life expectancy in order to receive a positive rate of return.

In the above-mentioned example, a 65 year-old male who contributes \$47,920 to receive monthly income of \$1,000 at the age of 80 would have to live for 48 months (age 84) in order to receive a positive rate of return. If the gentleman passed away before this time period, then he would receive only a return of principal, meaning that his rate of return would be zero. Based on IRS published life expectancy Table 2000CM, the average 65 year-old male has a 46% chance to live long enough to receive a positive rate of return. In order to receive a rate of return of roughly 3%, the gentleman would have to live until age 86. Under Table 2000CM, the gentleman has a 37% chance of living until age 86.

The authors have prepared a spreadsheet to illustrate the financial utility and tax implications of acquiring a QLAC under an IRA, relative to retaining in the IRA and continuing to invest in accordance with past practices the funds otherwise used to

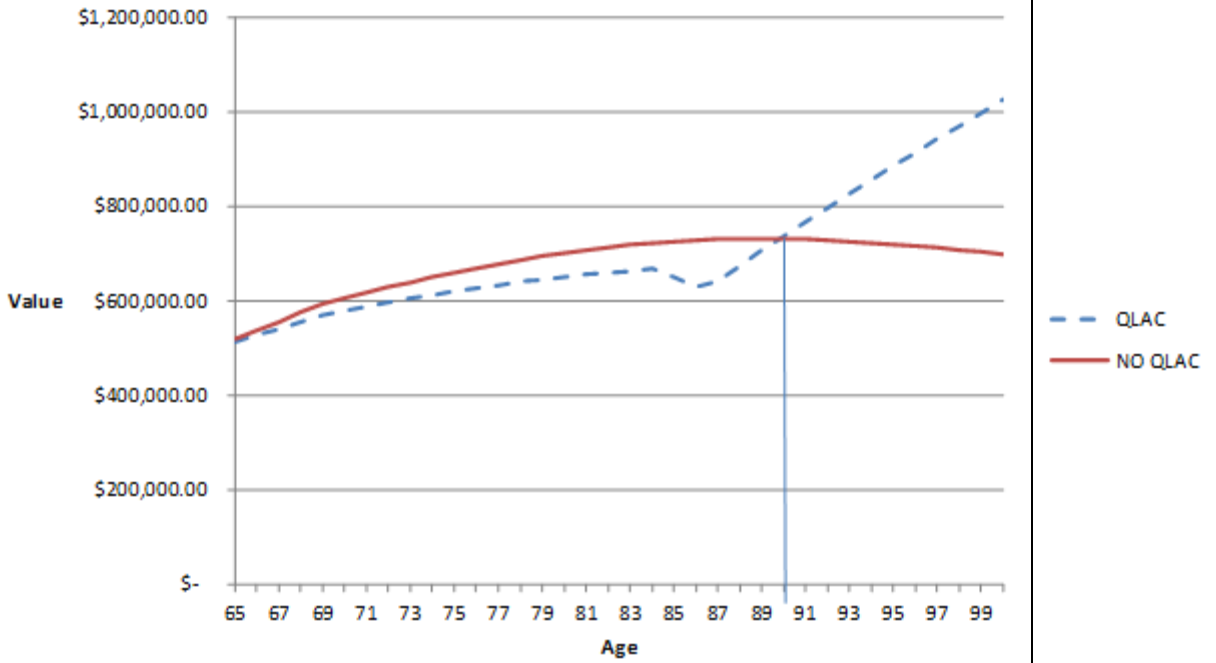
acquire the QLAC. One example assumes that a 65 year-old male taxpayer has \$500,000 in an IRA that is growing at 3.5% per year. The taxpayer invests the maximum premium amount of \$125,000 into a QLAC that will provide yearly payments of \$51,948 beginning when the taxpayer attains age 85. When required minimum distributions from the IRA begin upon the taxpayer attaining the age of 70 1/2, the QLAC will not count as part of the IRA balance, resulting in a reduction of the minimum distribution for that year by \$5,697.02 and resulting tax savings (deferral) for that year of \$2,220.73. At the age of 85 when the QLAC will begin to make payments, the taxpayer will have total tax savings of \$40,916.31.

All payments from the QLAC are fully taxable and made directly to the taxpayer, not into the IRA or other applicable retirement plan. The taxpayer is still required to take the required minimum distributions from the non-QLAC portion of his or her IRA or other applicable retirement plan, because neither the value of the QLAC nor the payments therefrom will count in determining the minimum distribution requirements. Any payments from the QLAC that occur after the annuitization beginning date will satisfy the required minimum distributions relating to the value of the QLAC.

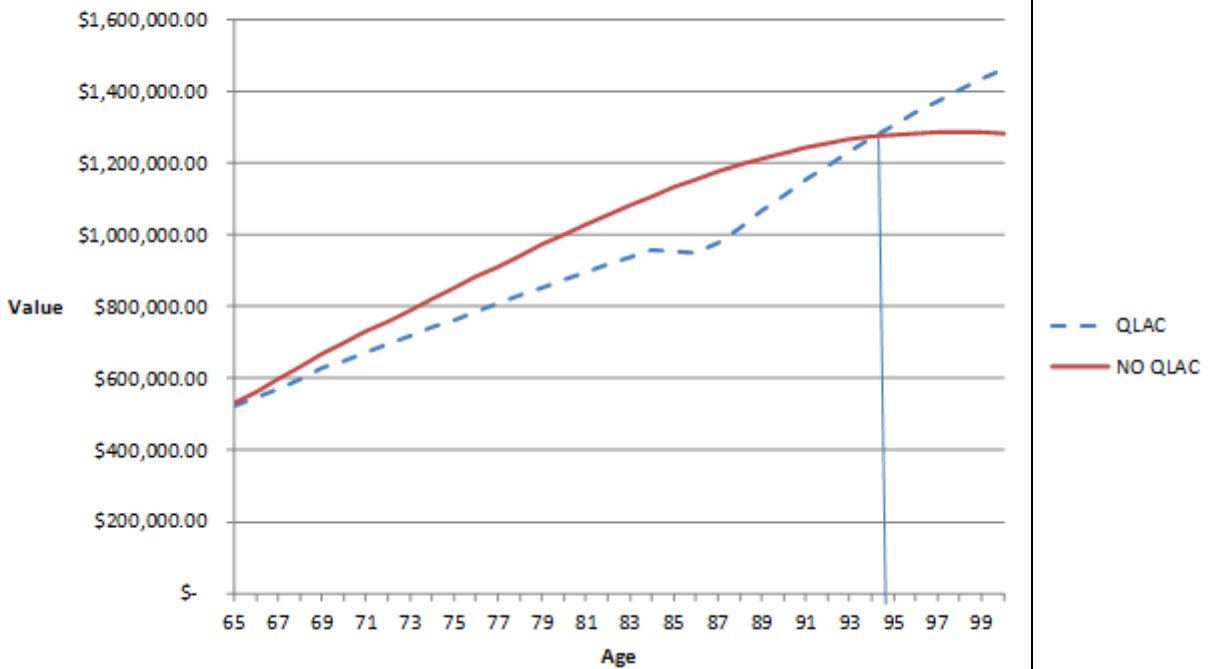
From an investment standpoint, the benefit of investing in a QLAC backfires and causes more harm than good if the taxpayer does not live long enough to have the contract provide a positive rate of return. For example, assume that the taxpayer does not invest \$125,000 in the QLAC, and instead leaves the funds in the IRA growing at 3.5% per year in order to compare the two options.

For the investment in the QLAC to provide a greater rate of return, than 3.5%, the individual would have to live to the age of 90. If the IRA was to grow at 6% per year, then the individual would have to live to the age of 95 in order for the QLAC to provide a higher rate of return. The longer that the individual lives, the greater the rate of return will be. Below is a chart comparing the two options at a 3.5% rate of return and at a 6% rate of return, based upon the value of the applicable portion of the IRA. A detailed spreadsheet showing the results of these options is available upon request.

### QLAC vs. No QLAC 3.5% Rate of Return



### QLAC vs No QLAC 6% Rate of Return



## Conclusion

The QLAC Regulations provide a flexible and possibly advantageous (but complicated) planning opportunity that could boost the popularity of longevity annuities as a retirement planning tool. The applicable Regulations provide potential tax savings by allowing a taxpayer to delay a portion of required minimum distributions from a retirement plan until the taxpayer attains the age of 85, although the potential tax savings could be offset by the financial performance of the QLAC relative to other investments if the taxpayer does not live to a certain age.

There will doubtlessly be interaction and confusion between these rules and the QLAC products, and between the traditional IRA and retirement plan investments typically undertaken by taxpayers and/or their plan administrators and QLACs from a financial investment standpoint. Practitioners would greatly benefit from literature and illustrations showing the real financial impact and results (taking into account both tax savings AND financial performance) of investing in a QLAC, which hopefully will be made available to the public when (or soon after) carriers release QLAC into the marketplace. It is important that planners run an appropriate analysis to determine whether a QLAC is a right fit for the client, in light of the client's possible life expectancy and expected rates of return from the investment.

## CITATIONS:

[i] For the purposes of this commentary, all references to "IRAs" refer only to non-Roth IRAs, including traditional IRAs described in Internal Revenue Code Section 408, SEP IRAs and SIMPLE IRAs, but not Roth IRAs unless specifically provided.

[ii] Internal Revenue Bulletin 2014-30, TD 9673.

[iii] Internal Revenue Bulletin 2014-30.

[iv] Treasury Regulation Section 1.401(a)(9)-6 A-17(c)(4)- Return of premiums—(i) In general. In lieu of a life annuity payable to a designated beneficiary under paragraph (c)(1) or (2) of this A-17, a QLAC is permitted to provide for a benefit paid to a beneficiary after the death of the employee in an amount equal to the excess of—

(A) The premium payments made with respect to the QLAC over

(B) The payments already made under the QLAC.

[v] Treasury Regulation Section 1.401(a)(9)-6, A-17(c)(1)(i): If the employee dies on or after the annuity starting date for the contract and the employee's surviving spouse is the sole beneficiary under the contract then, except as provided in paragraph (c)(4) of this A-17, the only benefit permitted to be paid after the employee's death is a life annuity payable to the surviving spouse where the periodic annuity payment is not in excess of 100 percent of the periodic annuity payment that is payable to the employee.

[vi] Treasury Regulation Section 1.401(a)(9)-8, A-2(a) and A-3.

[vii] Treasury Regulation Section 1.401(a)(9)-6 A-17(c)(1)(ii)(A): Amount of annuity. If the employee dies before the annuity starting date and the employee's surviving spouse is the sole beneficiary under the contract then, except as provided in paragraph (c)(4) of this A-17, the only benefit permitted to be paid after the employee's death is a life annuity payable to the surviving spouse where the periodic annuity payment is not in excess of 100 percent of the periodic annuity payment that would have been payable to the employee as of the date that benefits to the surviving spouse commence. However, the annuity is permitted to exceed 100 percent of the periodic annuity payment that would have been payable to the employee to the extent necessary to satisfy the requirement to provide a qualified preretirement survivor annuity (as defined under section 417(c)(2) or ERISA section 205(e)(2)) pursuant to section 401(a)(11)(A)(ii) or ERISA section 205(a)(2).(B) Commencement date for annuity. Any life annuity payable to the surviving spouse under

paragraph (c)(1)(ii)(A) of this A-17 must commence no later than the date on which the annuity payable to the employee would have commenced under the contract if the employee had not died.

<sup>[viii]</sup> Treasury Regulation Section 1.401(a)(9)-6 A-17(c)(2)(i): If the employee dies on or after the annuity starting date for the contract and the employee's surviving spouse is not the sole beneficiary under the contract then, except as provided in paragraph (c)(4) of this A-17, the only benefit permitted to be paid after the employee's death is a life annuity payable to the designated beneficiary where the periodic annuity payment is not in excess of the applicable percentage (determined under paragraph (c)(2)(iii) of this A-17) of the periodic annuity payment that is payable to the employee.

<sup>[ix]</sup>(iii) Applicable percentage—(A) Contracts without pre-annuity starting date death benefits. If, as described in paragraph (c)(2)(iv) of this A-17, the contract does not provide for a pre-annuity starting date non-spousal death benefit, the applicable percentage is the percentage described in the table in A-2(c) of this section.

<sup>[x]</sup> The table can be found at this link: [table](#)

<sup>[xi]</sup> Adjusted employee/beneficiary age difference Applicable percentage:

Year	Applicable Percentage	Year	Applicable Percentage
2 years or less	100%	14	34%
3	88%	15	32%
4	78%	16	30%
5	70%	17	28%
6	63%	18	27%
7	57%	19	26%
8	52%	20	25%
9	48%	21	24%
10	44%	22	23%
11	41%	23	22%
12	38%	24	21%
13	36%	25 and greater	20%

Alan,

I read with interest your discussion and analysis of QLACs in *Leimberg Newsletter # 639*. I have done similar analysis and offer several thoughts below for your consideration.

**Consider using a mortality table more reflective of the annuity buying population, and your affluent clients, than 2000 CM.**

The 2000CM mortality table is a unisex table derived from the 2000 U.S. census, i.e. the entire U.S. population. I would argue this population is less healthy, and has shorter life expectancy, than immediate or deferred immediate annuity purchasers.

People willing to trade current dollars for a stream of income for life believe they are healthy and will experience longevity. Insurance industry data demonstrates they are right, i.e. have life expectancy to a fully underwritten standard nonsmoker population.

While there is no data yet for the QLAC purchasing population, there may be even greater longevity among a self-selected population that agrees to pay \$125,000 at age 65 for an income stream that does not begin until age 85.

The latest insurance industry mortality table I am aware of is the 2012 Individual Annuity Mortality (IAM) Table. The summary below illustrates the significant difference in life expectancy and probability of survival between the 2000 CM and 2012 IAM tables.

**Life Expectancy and Probability of Survival**

**Comparison**

Life Expectancy				Age 65 Probability of Survival To Age:			
<u>Age</u>	<u>Table</u>	<u>2012 IAM Period</u>		<u>Age</u>	<u>2000 CM</u>	<u>2012 IAM Period</u>	
		<u>Male</u>	<u>Female</u>			<u>Male</u>	<u>Female</u>
65	17.77	22.30	24.18	80	61.81%	78.91%	83.47%
				85	41.92%	63.42%	70.50%
				90	22.47%	42.34%	50.72%
				95	8.36%	20.10%	28.55%

FYI, I have attached a life expectancy comparison for the 2 mortality tables from ages 65-110 with the year by year probability of survival comparison for a 65 year-old, and the 2012 IAM Period life expectancy for ages 26 to 105.

**Consider a QLAC analysis with a life only benefit, i.e. no refund feature.**

For a male age 65 a \$125,000 premium paid to New York Life buys a guaranteed monthly income of:

- \$4,214.03 (**\$50,568** per year) for **life with a cash refund**, and
- \$6,233.73 (**\$74,805** per year), **48% more**, for **life only**.

A QLAC is longevity insurance designed to provide income for those who live "too long". It is inefficient risk management to use the QLAC to cover both the risk of dying early and living too long. As William Baldwin argues in his article on this topic from *Forbes* (attached), buying the refund feature "*defeats the purpose of [QLAC] annuities, which is to enable retirees to live well without running out of money.*"



## **The QLAC is not for the wealthy**

**The retirement dilemma:** retirees want to maximize the spendable dollars from their assets, but they do not want to run out of money.

Since no one, except the very ill, know how long they will live, they calculate an annual asset consumption plan, e.g. 4% per year, designed to keep assets available until an age that is unlikely to be attained, e.g. 100. This results in most dying with assets remaining that they would have liked consume if they had only known they were available.

I think a good candidate for the QLAC is the client age 65 with \$1,000,000 of retirement assets. Using \$125,000 for a QLAC guarantees him and income of \$74,805 per year, beginning at age 85, and frees him to spend the remaining \$875,000 over the 20 years from 65 to 85. This strategy maximizes his spendable dollars in retirement, particularly in the early years, 65-85, when he can enjoy them. If he is one of the 37% that dies before age 85, the insurance did not "pay off", but that is alright for him because he did not need it. It did what was intended, i.e. gave him the freedom to spend the \$875,000.

I argue the wealthy are not good candidates for the QLAC because it is insurance, and they are insuring a risk, running out of money if they live too long, which is a risk they do not have. Since an insurance company, over all insureds, must pay out less in claims than it collects in premium and earns on the premiums, purchase of coverage by one who does not have the risk is a losing proposition.

### **My analysis**

I have attached my own version of an IRR analysis with the 2012 IAM Period mortality data, and it reaches conclusions similar to yours. I do include a calculation, based on current annuity rates, of the lump sum require at the QLAC payment date, e.g. age 85, to buy an annuity that matches the monthly payment from the QLAC, and the required annual compounded after-tax return on the QLAC premium to have this amount, **7.50%** for a male age 65.

While this analysis is of interest, it should be secondary in the QLAC purchase decision. The QLAC is insurance designed to shift the financial risk of living too long. If we knew how long we will live and the rate of return we will get on our assets, there is no need for the QLAC. The QLAC is a consideration because we do not know.

Please call if you would like to discuss.

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Richard Connolly  
Ward & Connolly  
5025 Arlington Centre Blvd, Suite 250  
Columbus, OH 43220  
Tel. (614) 486-9260    rconnolly@wchins.net    Fax. (614) 486-5103

## **Why The New Qualifying Longevity Annuity Contract (QLAC) Regulations Don't Mean Much For Retirement Income....Yet?**

**By: Michael Kitces, Posted Wednesday, July 9, 2014**

In recent years, a new form of retirement income annuity solution has been gaining visibility: the longevity annuity. A "cousin" to the more familiar immediate annuity, the goal of the longevity annuity is similar - to provide income for life - but the payments do not begin until years (or even decades) after the purchase. As such, these "deferred income annuities" can provide significantly larger payments when they do begin - e.g., at age 85 - in light of both the compounded interest and the mortality credits that would accrue over the intervening time period.

However, a fundamental complication of the longevity annuity is that if retirees want to use retirement account dollars but the payments might not begin until as late as age 85, there is a direct conflict with the required minimum distribution rules that compel payments to begin at age 70 1/2. To address this challenge, the Treasury has issued Treasury Regulations under 1.401(a)(9)-6 that resolve this conflict, declaring that as long as a longevity annuity meets certain requirements, it will be deemed a "Qualified Longevity Annuity Contract" (QLAC) and automatically be deemed to satisfy the RMD rules even though payments don't begin until later.

While the new Treasury Regulations may be a boon to annuity companies that wish to sell longevity annuities, though, it's unclear whether the new rules will really impact anytime soon, for the simple reason that longevity annuity purchases have been growing but still represent barely 1% of all annuity purchases; to say the least, consumers have not been banging down the door to buy such contracts, in their IRAs or otherwise. In fact, given that most consumers are reluctant to buy immediate annuities where they surrender their lump sum liquidity to receive payments for life, it's unclear why they would feel better about a similar contract with payments that don't begin for decades! And in the end, the actual internal rate of return on longevity annuity payments - even for those who live to age 100 - is not necessarily very compelling yet compared to available investment or even delayed Social Security alternatives. Nonetheless, when interest rates eventually rise, and as longevity annuity pricing becomes more competitive, the payout rates for longevity annuities will likely rise as well... and the new Treasury Regulations do at least open the door to longevity annuities inside of retirement accounts if they eventually become more compelling!

### **What Is A Longevity Annuity?**

The longevity annuity – also known in some circles as the Deferred Income Annuity (DIA) – is similar in principle to an immediate annuity, where a lump sum is converted into a lifetime stream of payments. The key distinction, however, is that with a longevity annuity, the payments for life don't begin immediately. Instead, they start at some point in the future.

For instance, a \$100,000 contract purchased by a 65-year-old couple might stipulate that payments will not begin until they reach age 85. However, the couple does reach age 85, payments of \$2,656.20 will commence and be payable for as long as either remains alive. Notably, the trade-off here is rather "extreme" – if the couple dies anytime between now and age 85 (assuming both pass away), the \$100,000 is lost. However, if they merely live half way through age 88, they will have recovered their entire principal, and from there will continue to receive \$31,874.40/year thereafter, a significant payoff for "just" \$100,000 today.

Of course, the payout rates will vary depending on the starting age. If the 65-year-old couple begins payments at age 75 instead of 85, the monthly payments are only \$934.18/month, instead of \$2,656.20. The couple could also purchase a single premium immediate annuity at age 65 with payments that start immediately, but the payouts would only be \$478.91/month. Thus, in essence, by introducing a 10-year waiting period, the payments more than double; by waiting 20 years, the payments more than quintuple! And if the couple starts even earlier, the payments are greater; a longevity annuity purchased for \$100,000 at age 55 with payments that don't begin until age 85 receive a whopping \$4,054.10/month (\$48,649.20/year!) if at least one of them remains alive to receive the payments! Alternatively, the couple could include a return-of-premium death benefit (to the extent the original \$100,000 is not recovered in annuity payments, it is paid out at the second death to the beneficiary), which would drop the payments to a still-significant \$3,690.30/month. *(Quotes are from Cannex, as of 7/8/2014)*

In essence, the concept of the longevity annuity is to truly hedge against longevity; while the couple may receive limited payments if they don't survive, the payments are *very* significant relative to the starting principal if they do live long enough; in fact, the payments can be so "leveraged" against mortality that the couple doesn't *actually* need to set aside very much in their 50s and 60s to fully "hedge" against living beyond age 85 (which also makes it easier to invest for retirement when the time horizon is known and fixed to just cover between now and age 85!).

In theory, a longevity annuity could be purchased with after-tax dollars (a non-qualified annuity), or within a retirement account. After all, the reality is that for many people, the bulk of their retirement savings is currently held within retirement accounts, and if there's a goal to use a longevity annuity to hedge against long life, those are the dollars to use!

Unfortunately, though, there's a major problem with holding a longevity annuity inside of a retirement account: how do you have a contract that doesn't begin payments until age 85 held within an account that has required minimum distributions (RMDs) beginning at age 70 ½!?

### **Final Treasury Regulations To Coordinate An RMD And A Longevity Annuity**

To address the fundamental conflict between the structure of a longevity annuity and the RMD rules, the Treasury issued Proposed Regulations 1.401(a)(9)-6 in 2012, and the Regulations were finalized last week. The basic approach of the Regulations is to define a "Qualified" Longevity Annuity Contract (QLAC), and then declare that any longevity annuity that meets the QLAC requirements will not be in conflict with the RMD rules.

To be eligible as a QLAC, a longevity annuity must meet the following requirements:

- Only 25% of any employment retirement plan (or 25% across all pre-tax IRAs aggregated together) can be invested into a QLAC.
- The cumulative dollar amount invested into ALL QLACs across all retirement accounts may NOT exceed the LESSER of \$125,000 (original regulations were only \$100,000), or the aforementioned 25% threshold. The \$125,000 dollar amount will be indexed for inflation, adjusted in \$10,000 increments.
- The limitations will apply separately for each spouse with their own retirement accounts.
- The QLAC must begin its payouts by age 85 (or earlier)

- The QLAC must provide fixed payouts (not variable or equity-indexed), though it may have a cost-of-living adjustment (COLA)

- The QLAC cannot have a cash surrender value once purchased (i.e., it must be irrevocable and illiquid), but it can have a return-of-premium death benefit payable to heirs as a lump sum or a stream of income

If the longevity annuity meets the above requirements to be deemed a QLAC, then the value of the QLAC is excluded when calculating RMDs (for other retirement assets), and the payments from the QLAC (whenever they begin) are implicitly assumed to satisfy their RMD obligation (though the QLAC payments will not satisfy RMDs for any *other* retirement accounts).

*Example.* Jeremy purchased a \$50,000 QLAC at age 65 that will begin payments of \$15,937/year at age 85. In addition, he has \$400,000 of other IRA assets. By age 70 ½, his IRA has grown to \$600,000, and he must begin to take RMDs from the account. His RMDs will be calculated only on the \$600,000 account balance, and not include any implied value from the QLAC. Moreover, when Jeremy turns 85 (and we'll assume his IRA is up to \$900,000), he will begin to receive his \$15,937/year payments from the QLAC begin, he will *still* have to take RMDs from his \$900,000 IRA (and cannot count any of the \$15,937/year QLAC payments towards his IRA's RMD). The \$15,937/year payments from the QLAC itself will automatically (because the QLAC was qualified in the first place) be deemed to meet the RMD rules for that portion of Jeremy's assets.

Notably, longevity annuities purchased in Roth accounts are not considered QLACs, for the simple reason that Roth IRAs do not have RMDs to comply with in the first place; as a result, an unlimited amount of longevity annuities could be purchased within a Roth IRA (if desired), and the account balances and longevity annuities inside Roth IRAs are not counted towards the \$125,000 and 25% limits.

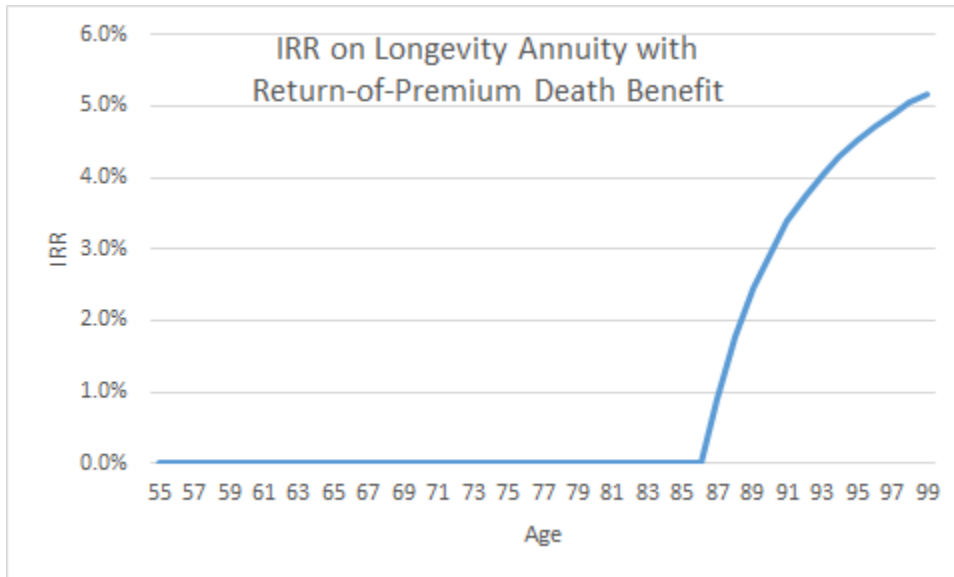
For contracts purchased in traditional retirement accounts (IRAs or employer retirement plans), the dollar and percentage limits do apply. In practice, most investors will be limited to 25% of retirement accounts, as until they have at least \$500,000 of retirement accounts the 25% limit will hold (only with accounts greater than \$500,000 would the \$125,000 dollar limit be the lesser of \$125,000-or-25%). On the other hand, each spouse could invest this much into a QLAC, effectively doubling the longevity annuity amount for a couple (if desired).

### **You Can Now Buy A Longevity Annuity In An IRA, But Should You?**

While the QLAC rules allowing a longevity annuity to be owned inside of a retirement account were essential to avoid running afoul of the RMD rules, the question still arises: a (qualified) longevity annuity can be now purchased inside of a retirement account... but will anyone actually *want* to?

Thus far, the industry statistics suggest that demand for the products is still weak. In 2012, longevity annuity purchases topped \$1B for the first time (averaging \$250M per quarter), and in the first quarter of 2014 they're up to \$620M (an annual pace of almost \$2.5B). However, the first quarter of 2014 also saw \$57.7B of total annuity sales, which means longevity annuities only make up barely more than 1% of all new annuity transactions. By contrast, even single premium immediate annuity purchases were \$2.5B in Q1 of 2014, nearly quadruple the pace of longevity annuities. Nonetheless, interest in longevity annuities does seem to be growing, and more companies are throwing their hats into the ring with new products.

At a more basic level, though, the fundamental challenge is that in a world where consumers are often loath to purchase an immediate annuity – ostensibly out of concern for losing their liquidity and their upside potential – it seems even more of a stretch for a longevity annuity to be compelling, with the same problems but no payments until what may be decades from now. Fortunately, the common “what if I get hit by a bus” fear can be mitigated at least, with the purchase of a return-of-premium death benefit, though such guarantees just lower the payments even further. For instance, the 55-year-old who purchases a longevity annuity for \$100,000 will get guaranteed payments of \$3,690.30/month starting at age 85 with a return-of-premium death benefit along the way. However, if we calculate the actual internal rate of return being generated on the longevity annuity over the time period, the results turn out to be less compelling, as shown below.



As the results reveal, it still takes until age 87 before the couple actually receive back their original principal and begin to generate any actual “return” on their dollars. Even by age 90, the internal rate of return is only 3%, and by age 100 it’s still only 5.3%. While 5.3% certainly isn’t a “bad” return from an annuity company, over a 45-year time horizon it’s still not a very compelling return either, as a combination of both interest rates and mortality credits. Even in today’s low-return environment, long-term corporate bonds pay close to those yields, and the long-term return on equities is highly likely to beat 5.3% over 45 years as well (especially given that *no cash flows are assumed for 30 years*, which provides a significant barrier to fend off market volatility along the way).

In other words, while it might be nice that a longevity annuity can give a significant payment that’s “guaranteed for life” beyond age 85, if its internal rate of return is low enough, the truth is that a simple conservative investment over the same time horizon might have generated even more cash flow over any foreseeable age of death (even with very long life). Similarly, the reality is that delaying Social Security – which itself is implicitly a longevity annuity – still has a far better implicit payout rate as well compared to today’s commercial longevity annuities, especially given that Social Security is inflation-adjusted while a longevity annuity also runs the risk that unexpected inflation will significantly degrade the purchasing power of its guaranteed income. (Some contracts do provide inflation-adjusted payments starting *after* age 85, but still require the retiree to “guess” - and risk being wrong - at what inflation will be between today and when payments begin.)

Notwithstanding the not-terribly-compelling implied returns that longevity annuities provide in today’s marketplace, the potential remains for longevity annuities to become an increasingly significant part of the retirement income puzzle, especially if/when/as interest rates rise (boosting

future payouts), and/or more companies enter the marketplace (potentially making longevity annuity pricing more competitive – i.e., with higher payouts). And for those who do find a longevity annuity compelling, for at least a portion of retirement income... the new QLAC regulations do at least *permit* investors to own such contracts inside their retirement accounts. And while the dollar amount contributions remain limited, from a practical perspective a retiree would likely only put a portion of funds into a longevity annuity anyway (as they still need to fend for themselves between now and when payouts begin!).

In the end, though, whether prospective retirees *will* pursue such trade-offs or not remains to be seen, and thus far it appears the "breakthrough" of the QLAC regulations is more about permitting insurance companies *to* sell longevity annuities inside of retirement accounts than consumers demanding to do so, especially once guaranteed payouts are converted into the equivalent not-terribly-high return they're providing over the ultra-long time horizon. Nonetheless, if guaranteed future payouts get higher in the coming years as rates rise and the marketplace heats up, longevity annuities might get a whole lot more interesting.

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Michael E. Kitces, MSFS, MTAX, CFP, CLU, ChFC, RHU, REBC, CASL  
Pinnacle Advisory Group, Inc.  
6345 Woodside Court, Suite 100  
Columbia, Maryland 21046  
Tel. (410) 995-6630 michael@kitces.com Fax. (410) 505-0960

## CHAPTER 12

### **SYNTHETIC VARIABLE ANNUITIES THAT CAN BE TREATED AS FIXED ANNUITIES FOR COST AND CONTRACT ALLOCATION AND 10% EXCISE TAX PURPOSES**

As discussed in Chapter 2, Private Letter Rulings have been issued which have permitted certain variable annuity contracts to have payments made qualify for the two advantages that annuitized contracts have over normal deferred variable annuities:

1. The percentage of the contract value attributable to built-in income multiplied by each withdrawal would be the measure of taxable income, in lieu of all income being considered to come out first with each distribution from the contract; and
2. Payments will not be subject to the 10% excise tax that applies when the contract holder is not an individual who has reached age 59 ½ or does not otherwise meet an exception to the 10% excise tax.

The applicable Private Letter Rulings were all issued to Lincoln Financial Group in the years 2002 through 2008. Lincoln Financial Group patented the administrative process behind this rider and calls it the “Lincoln i4LIFE® Advantage rider.” AXA has recently come out with a product that operates in a similar fashion to the i4LIFE® Advantage rider, and other carriers are expected to do the same, assuming that the patent laws would not prevent this.

The authors have no direct or indirect financial relationship with Lincoln Financial Group, and the costs associated with these annuities should be carefully considered before they are entered into. Because a large number of insurance agents are familiar with and recommend the i4LIFE® product, the authors felt that it was important to include this chapter. The authors thank Christopher Price of Lincoln Financial Group for his assistance in preparing this chapter and many others.

The Lincoln i4LIFE® Advantage arrangement permits a Lincoln variable annuity owner to maintain a cash value variable annuity arrangement that can provide market exposure to grow (or decline) like most variable annuities, while also receiving annual or more frequent payments that will not be 100% taxable because of the ability to allocate tax basis to each payment in the same way that applies to annuitized contracts.

The IRS approved this technique in Private Letter Rulings 200305018 and 200818018. The i4LIFE® Advantage rider gives policyholders a vehicle that provides exposure to the stock markets, periodic payments, ability to make withdrawals in excess of annual payments, and minimum guarantees, along with the tax advantage of applying the investment in the contract (exclusion ratio) to annual payments before the annuitization period. Also, it can be used in wealth transfer planning in a number of beneficial ways to both policyholders and beneficiaries.

The i4LIFE® Advantage rider can provide payments over an individual’s lifetime. It is an “annuity payout option which combines periodic variable Regular Income Payments for life and a death benefit with the ability to make withdrawals during . . . the Access Period.”<sup>48</sup> The i4LIFE® Advantage combines several parts of an annuity to provide flexibility and ensure that an individual will have income from the annuity contract and customize structures.

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<sup>48</sup> Lincoln Prospectus for Variable Annuities, Page 6; The IRS refers to the Access Period as Phase I in the private letter rulings described above.

The Lincoln i4LIFE<sup>®</sup> Advantage rider has two phases: the “**Access Period**” and the “**Lifetime Income Period**.” The Access Period is a defined period during which the owner receives annual or more frequent payments, but still has access to greater withdrawals of the account balance.<sup>49</sup> In other words, the owner can withdraw from the account, surrender the contract, and have a death benefit. The owner chooses the duration of the Access Period when the i4LIFE<sup>®</sup> Advantage rider is selected. When the Access Period ends, the owner must enter into the Lifetime Income Period. During the Lifetime Income Period, the owner receives scheduled payments, but does not have access to the account. The Lifetime Income Period continues until the death of the owner or the annuitant.

For example, John purchases a variable annuity contract with the i4LIFE<sup>®</sup> Advantage rider under the i4LIFE<sup>®</sup> Advantage arrangement. John can change the payment frequency, withdraw more than the scheduled annual payment, and have other flexibilities. His payments will be taxed under the exclusion ratio rules. At the end of the Access Period, the Lifetime Income Period begins, and John will receive annual payments during his lifetime, but will no longer have the ability to receive monies other than the agreed payments.

### **i4LIFE<sup>®</sup> Advantage Access Period**

The i4LIFE<sup>®</sup> Advantage “Access Period” is the time when the contract owner receives scheduled periodic withdrawals based on his requested frequency and still has access to the account to make withdrawals.<sup>50</sup> The scheduled periodic withdrawals are called Regular Income Payments and come out of the Account Value of the contract. In addition to the Regular Income Payments, the contract owner can request additional withdrawals. In ordinary annuity contracts, these payments would be considered withdrawals and taxed using the LIFO (“last in, first out”) rule which requires that the interest earned under the contract to be withdrawn first. This likely means that the entire withdrawal will be subject to tax. Under the i4LIFE<sup>®</sup> rider these “Regular Income Payments” are taxed under the exclusion ratio rules, meaning that each payment will be considered to include a certain portion of the original cost of the contract, and will thus not all be subject to income tax that will apply under most variable annuity contracts that are not yet annuitized. During this Access Period, the contract owner has a death benefit and can change the periodic payment frequency not more than once per year.

The contract owner selects the duration of the Access Period when the i4LIFE<sup>®</sup> Advantage rider is adopted.<sup>51</sup> The duration of the Access Period will determine the amount of Regular Income Payments. The minimum and maximum lengths available for the Access Period are based on the i4LIFE<sup>®</sup> Advantage rider.<sup>52</sup> Generally, a longer Access Period will result in smaller payments, while a shorter Access Period will result in larger payments.

The contract owner can extend or shorten the Access Period, subject to certain rules.<sup>53</sup> For example, if a contract owner extends the Access Period, he must extend it for at least 5 additional years.<sup>54</sup> If the Access Period is changed, the Regular Income Payments are adjusted. During the

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49 Lincoln Variable Annuity Prospectus, P. 5.

50 Id. at 5.

51 Lincoln Variable Annuity Prospectus, P. 91.

52 FN 2 at 91. The Lincoln prospectus, states that shorter Access Periods will produce higher initial Regular Income Payments than longer Access Periods.

53 Lincoln Variable Annuity Prospectus, P. 91.

54 Id.



Access Period, the Account Value changes to reflect Accumulation Units,<sup>55</sup> the fixed amount of the contract, and reductions caused by withdrawals.

Following the Access Period, the annuity must enter into the Lifetime Income Period if the annuitant is living.<sup>56</sup> During this period, withdrawals, the surrender option, and death benefit are no longer available.<sup>57</sup> The Account Value at the end of the Access Period is used to calculate the Regular Income Payments for the Lifetime Income Period, which is described below.<sup>58</sup>

Example: James is 62 years old and his wife, Mary, is 64. They purchased Lincoln variable annuity for \$500,000 that is worth \$1,000,000. They have not made any withdrawals from the contract. They select the i4LIFE® Advantage rider and can elect to receive annual payments as low as \$44,755 per year, or as high as \$51,319 per year, with an Access Period not less than 28 years and not more than 53 years. Each payment will be considered to include a certain portion of the original cost of the contract, and will thus not all be subject to income tax as can otherwise apply under most variable annuity contracts that are not yet annuitized. In either event, the Guaranteed Income Benefit rider level would be \$40,000 per year, meaning that this amount would be paid annually, regardless of market performance, in exchange for an additional annual percentage of value charge imposed for the rider.

If James and Mary select the lowest annual payment option, then based upon their investment in the contract, \$9,294 of each \$44,755 payment will be received as a tax-free return of basis. If they select the highest annual payment portion, then the portion of each payment that is tax-free is \$16,171. Under the highest annual payment option, if the contract has no additional earnings, and James and Mary take a \$50,000 withdrawal from the contract in the fourth year, then the contract has a value of \$794,724 (\$1,000,000 minus four payments of \$51,319) and the basis at the time of the withdrawal is \$435,316 (\$500,000 minus 4 tax free amounts received of \$16,171). At the time of the withdrawal, the basis represents 54.78% of the contract value. 54.78% of the \$50,000 unscheduled withdrawal, \$27,388, will not be taxed and the balance of \$22,612 will be taxable.

Income ranges can be higher or lower if the contract does not include the Guaranteed Income Benefit Option. The assumed interest rate can be from 3% to 6% and the Access Period can be as short as 5 years. The chart below that was provided by Lincoln Financial Group shows the range of starting payments available under the i4LIFE® Advantage rider for individuals ages 50, 60, and 70, based upon a \$1,000,000 account value and October 2013 assumptions. Payments will vary after the initial payment to reflect market performance.

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<sup>55</sup> Id. at 45. Accumulation Units is the terminology used to characterize the variable side of the annuity contract. At its most basic interpretation, it represents a calculation used to reflect investment performance, expenses, and contract charges.

<sup>56</sup> The IRS refers to the Lifetime Income Period as Phase II in their private letter rulings.

<sup>57</sup> According to the sales literature, the greatest benefit of the i4LIFE® Advantage rider is its ability to provide periodic Regular Income Payments for the life of the annuitant, or secondary annuitant, while providing unrestricted access to the Account Value during the Access Period. This could be beneficial where a contract owner faces an unexpected need for money, but does not want to terminate the annuity. For example, Tom has purchased a Lincoln Variable Annuity with the i4LIFE® Advantage rider. During the Access Period, one of Tom's children needs to borrow money from him, but he has limited funds himself, as he has placed his money into purchasing the annuity contract. With the i4LIFE® Advantage rider, Tom can make a withdrawal at any point during the Access Period, and so long as his account balance does not decrease to zero, the only consequence he will face is a subsequent decrease in income and the future guaranteed minimum income.

<sup>58</sup> Lincoln Variable Annuity Prospectus, P. 91.

**Minimum and Maximum Starting Annual i4LIFE® Advantage Payments Based on \$1,000,000 Account Value**

		Single Owner/Annuitant				Joint Owners/Annuitants			
		Minimum Payment*	Non-taxable Portion	Maximum Payment**	Non-taxable Portion	Minimum Payment*	Non-taxable Portion	Maximum Payment**	Non-taxable Portion
Age at start	50	\$34,122	\$9,821	\$65,202	\$29,665	\$34,122	\$15,113	\$60,223	\$25,189
	60	\$36,755	\$13,636	\$73,095	\$40,190	\$36,261	\$17,881	\$64,913	\$33,113
	70	\$39,597	\$20,000	\$87,488	\$59,280	\$39,597	\$21,327	\$74,381	\$47,393

\*3% Assumed Interest Rate with Maximum Access Period (50 yrs old – 65 years; 60 yrs old – 55 years; 70 yrs old – 45 years)

\*\* 6% Assumed Interest Rate with Minimum Access Period (5 years)

**i4LIFE® Advantage Regular Income Payments**

The annuity contract requires that Regular Income Payments start within one year of the purchase date of the i4LIFE® Advantage rider and continue until the later of the end of the Access Period or the death of the annuitant(s).<sup>59</sup> Regular Income Payments are distributed throughout the Access Period and the Lifetime Income Period. The owner chooses the frequency of the payments and how often the payments are recalculated.<sup>60</sup> While the owner is able to choose many factors that influence the amount of the payments, the owner cannot choose the exact payment amount. The payment amount is calculated by Lincoln.<sup>61</sup>

Any additional withdrawals made during the Access Period will cause the Account Value to go down, which in turn causes the Regular Income Payments amount to change.<sup>62</sup> In other words, if the owner withdraws from the account during the Access Period, he will have a lower amount to use when calculating Regular Income Payments. The amount at the end of the Access Period, not the initial contract amount, determines the amount of the Regular Income Payments.

**i4LIFE® Advantage Guaranteed Income Benefits**

The Guaranteed Income Benefit feature for the i4LIFE® Advantage rider provides contract owners with a guarantee that a selected minimum payment will continue regardless of whether the contract loses its value.<sup>63</sup> This benefit will not apply unless the Regular Income Payment falls below the Guaranteed Income Benefit.<sup>64</sup> The specifics of this option have changed regularly. As of October 2013, the only option available for new contract holders is the “version 4 option.”<sup>65</sup> Under this

<sup>59</sup> 5Lincoln Variable Annuity Prospectus, P. 91.

<sup>60</sup> Id.

<sup>61</sup> Lincoln calculates the amount of the Regular Income Payments by dividing the contract value, less the premium taxes, by 1,000 and multiplying by an annuity factor. The annuity factor is based on the age and sex of the annuitant(s), the length of the Access Period, the frequency of the payments, the assumed investment return selected, and the Individual Annuity Mortality table specified in the contract. See Lincoln Variable Annuity Prospectus, P. 92.

<sup>62</sup> 8Lincoln Variable Annuity Prospectus, P. 92.

<sup>63</sup> FN 2 at 96. The initial Guaranteed Income Benefit is defined as an amount equal to a specified percentage of your Account Value based on your age (or the age of the youngest life under a joint life option) at the time the Guaranteed Income Benefit is elected.

<sup>64</sup> Lincoln Prospectus for Variable Annuities, Page 98

<sup>65</sup> Id. at 96

option, if the Account Value reaches zero the Access Period ends and the Lifetime Income Period begins.<sup>66</sup> Payments will continue until the death of the contract holder.<sup>67</sup>

Election of this option requires the contract owner to follow specific investment guidelines.<sup>68</sup> Contract owners may only choose subaccount investments from a particular list, and there are limitations on the amount that may be invested in particular listed investments. The investment requirements are listed under three different options, with different riders subject to the different terms.<sup>69</sup>

### **i4LIFE® Advantage Private Letter Rulings**

Two Private Letter Rulings (PLRs)<sup>70</sup> were issued in 2002 and 2008 regarding the i4LIFE® Advantage riders. Private Letter Ruling 200305018 examined five different aspects of the Lincoln Variable Annuity with the i4LIFE® Advantage rider to determine whether the annuity would be considered an annuity for tax purposes. Private Letter Ruling 200818018 examined whether the Lincoln Variable Annuity with the i4LIFE® Advantage rider would constitute an immediate annuity under Section 72(u)(4) for tax purposes, and could therefore be held by a non-natural person and still receive the tax-deferral benefits under Section 72.

Although Private Letter Rulings only serve to bind the IRS as to the requesting taxpayer, these Private Letter Rulings are specifically about the i4LIFE® Advantage rider by Lincoln Financial Group and confirm the appropriate tax reporting for the i4LIFE® Advantage products. The Private Letter Rulings also provide Lincoln with guidance for reporting taxable income of policyholders if they receive i4LIFE® Advantage payments.

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66 Id. at 98

67 Id.

68 FN 2 at 55.

69 The following was provided to the authors by Lincoln Financial Group:

The i4LIFE® Advantage rider is not required to adhere to any investment requirements unless the Guaranteed Income Benefit is attached. The most current version, Version 4 mentioned above, of the Guaranteed Income Benefit must follow the requirements established under Option 3. As mentioned previously, depending on the rider purchased, different investment requirements may be relevant. The alternative versions of the Guaranteed Income Benefit, versions 1, 2, and 3, are subject to different investment requirements, but the discussion below is limited to an examination of the investment requirements relevant to version 4 only or on a rider elected date on or after November 15, 2010.

Electing the i4LIFE® Advantage rider will not subject a contract owner to any particular investment requirements. These requirements are utilized by Lincoln to ensure contract owners' investments are the safest options to lead to positive future growth while minimizing Lincoln liability in supplying the guarantee by requiring contract owners to invest in what Lincoln finds to be stable investment options. The investment requirements limit contract owners' subaccount investments to particular investments that are listed within different groups under the different options. These groups have different percentages attached to them. The attached percentages represent the minimums and maximums of the different investment groups that may be included within a contract owner's subaccount.

A contract owner can choose to invest at most 70% of the account value into the investment options listed under Group 2, and must invest at least 30% of the account value in the investment options listed under Group 1. For example, LVIP Delaware Bond Fund is an investment listed in Group 1, which requires at least 30% of the contract value to be invested in the investments listed in Group 1. LVIP JPMorgan Mid Cap Value RPM Fund is an investment listed under Group 2, which requires no more than 70% of the contract value to be invested in the listed investments. For example, if Tom has an account value of \$100,000 and has purchased the i4LIFE® Advantage rider with the Guaranteed Income Benefit, he may invest at most \$70,000 in the JP Morgan Mid Cap Value RPM Fund, but he must invest at least \$30,000 in the LVIP Delaware Bond Fund.

In addition to the above two listed groups, there is a third group listed under the Option 3 investment requirement. This group contains one fund name, the LVIP BlackRock Emerging Markets RPM Fund, and contains a limitation restricting investment to no more than 10% of the account value. Finally, Option 3 provides an alternative investment option, where contract owners may invest the entirety of the account value among a list of twelve investments, made up from both Groups 1 and 2 listed above, so the investment requirements from these groups do not apply.

70 PLRs 200305018 and 200818018.

*Private Letter Ruling 200305018*

Private Letter Ruling 200305018 considered the issue of whether Lincoln's variable annuity contract was deemed to be an annuity under Section 72. The Private Letter Ruling reviewed the i4LIFE<sup>®</sup> Advantage rider, noting that it granted "a stream of periodic income payments over the lifetime of one or two annuitants based on the investment experience of the amounts paid in on the contract and, where appropriate, a credit when the contract has been in force for a stated number of years."<sup>71</sup> The IRS examined five issues in this Private Letter Ruling: (1) whether payments began following the annuity starting date; (2) the differences in the tax treatment between amounts received as an annuity and amounts not received as an annuity; (3) the computation of the amount received as an annuity; (4) the consequences on the exclusion ratio for changing the length of the different phases of the contract; and (5) whether the presence of a surrender feature constituted income.<sup>72</sup>

The contract payments were broken up into two time segments, Phase I and II. Phase I is the Access Period. Phase II is the Lifetime Income Period. Phase IIA is a period with guaranteed payments. During this period, the owner could specify that a certain number of periodic payments be made regardless of the survival of any annuitant. During Phase IIA, the owner receives only the regular periodic scheduled payments, and has no further option to cash in the policy or change it in any way.

*Ruling #1*

The first issue was whether payments under the rider are treated as if they were made on or after the annuity starting date for tax purposes. Section 72(c)(4) defines the annuity starting date as "the first day of the first period for which an amount is received as an annuity under the contract." Under Tax Regulation 1.72-4(b)(1), "the first day of the first period for which an amount is received as an annuity shall be [the later] of the following [two dates]: (i) the date upon which the obligations under the contract became fixed, or (ii) the first day of the period ... which ends on the date of the first annuity payment."

The IRS held that the payments made under the i4LIFE<sup>®</sup> Advantage rider become "fixed", and would therefore be treated as made on or after the annuity starting date. Under the i4LIFE<sup>®</sup> Advantage rider, the obligations were fixed no later than the commencement date selected by the contract owner and the first annuity payment was due within 14 days of this date.<sup>73</sup> The IRS concluded that the payments were made on or after the annuity starting date.<sup>74</sup>

*Ruling #2*

The Private Letter Ruling next addressed the tax treatment of amounts received as an annuity. Under Section 72(b)(1), gross income will not include the part of any amount received as an annuity with the same ratio as the investment in the contract as of the annuity starting date to the expected return under the contract. For variable annuities, Regulation 1.72-4(d)(3)(i) states that amounts received as an annuity are subject to the exclusion ratio, which is equal to 100%. However, any amounts received from a variable annuity contract in excess of the expected return (i.e., the income on the contract) are fully includible in gross income.

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71 8PLR 200305018

72 Id.

73 PLR 200305018

74 Id.

The IRS held that Lincoln's i4LIFE® Advantage rider is a variable annuity and is subject to the rules of Regulation 1.72-4(d)(3)(i).

### Ruling #3

The third ruling dealt with computation of the income from the amounts received as payments. Under Regulations 1.72-4(d)(3), the amounts considered as an annuity will only equal the investment in the contract. The investment in the contract that is allocable to a particular year is excludable from gross income, and is based on the investment in the contract divided by the number of periodic payments anticipated during the time that periodic payments are to be made. The investment in the contract must be adjusted if refund features exist. Section 72(c)(2) explains that refund features are present when: (1) the expected return depends on the life expectancy of one or more individuals; (2) the contract provides for payments to a beneficiary on or after the death of the annuitant(s); and (3) payments are a refund of the consideration paid.

The IRS determined that a refund feature was present in the i4LIFE® Advantage Annuity rider because the expected return depends on the life expectancy of the annuitant(s) and the existence of a death benefit during Phase I.<sup>75</sup>

In addition, Regulations 1.72-2(b)(3)(i) state that an amount will be treated as an annuity so long as it does not exceed the investment in the contract divided by the expected number of periodic payments. Payments to be made for the life of the annuitant must be calculated based on the tables in Sections 1.72-9 and -5 in determining the number of periodic payments.

### Ruling #4

The fourth ruling considers the effect on the exclusion ratio when changing the length of either Phase I or Phase IIA. Changing the length of the Phases changes the amount of the periodic payments. If a Phase is shortened, then the payment amounts will increase. If a Phase is lengthened, the payment amounts decrease. However, changing the length of either phase will not change the exclusion ratio.

Regulation 1.72-4(a)(3) provides that “where the periodic payments increase in amount after the annuity starting date in a manner not provided by the terms of the contract at such date, the portion of such payments representing the increase is not an amount received as an annuity.” This suggests that increasing the periodic payment does not change the amount received as an annuity. This change could result in recognition of ordinary income. The Regulations also deal with annuity payments that differ in amount, duration, or both, from the original payments under the contract.<sup>76</sup> Under Regulation 1.72-11(e), if the duration of the new payments differs from the duration of the old payments, then Regulation 1.72-11(e) applies to the new annuity to cause the additional payments to be treated as received as an annuity under a new contract that is considered as exchanged for the initially acquired contract.

Under the i4LIFE® Advantage rider, changing the length of either Phase I or IIA did not change the duration of the Rider, but instead changed the duration of the guaranteed periodic payments. Therefore, Regulation 1.72-11(e) does not apply when there is a change in the Phases and will not result in a change in the exclusion ratio.

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<sup>75</sup> Id.

<sup>76</sup> Treas. Reg. 1.72-11(e)

## Ruling #5

In the final ruling, the IRS determined whether the surrender value under the contract would cause the taxpayer to recognize income. A surrender feature in the i4LIFE® Advantage rider allows contract holders to surrender the amount in the contract. Section 72(a) states that taxes will only apply to amounts “actually received.” Under Section 451(a), gross income is included when it is “actually or constructively received” by the taxpayer.

The IRS cited to Revenue Ruling 68-342, in which the IRS held that “the cash value of a qualified annuity contract was not made available to the holder by a surrender feature.” This surrender feature also subjected the taxpayer to “substantial limitations,” because of surrender charges. The IRS upheld the prior ruling and concluded that the presence of a surrender value will not cause the taxpayer to recognize income.

### *Private Letter Ruling 200818018*

Private Letter Ruling 200818018 involved whether the variable annuity and rider described in the Private Letter Ruling would be considered an “immediate annuity” within the meaning of Section 72(u)(4). Characterizing this product as an immediate annuity is essential because it can have serious tax repercussions. For example, the immediate annuities exception to the 10% excise tax is applicable. Because the taxpayer’s annuity contract met the requirements of an immediate annuity under Section 72(u)(4), the taxpayer was not subject to the 10% excise tax under Section 72(q). It has been suggested that this conclusion shows that a non-person can hold a tax-deferred annuity and receive the above result.

Section 72(u)(4) defines an immediate annuity as “an annuity (A) which is purchased with a single premium or annuity consideration, (B) the annuity starting date ... of which commences no later than 1 year from the date of the purchase of the annuity, and (C) which provides for a series of substantially equal periodic payments (to be made not less frequently than annually) during the annuity period.”

The IRS conceded that the i4LIFE® Advantage rider was paid by a single premium, the annuity starting date started no later than 1 year from the purchase date, and payments were made not less frequently than annually. The only issue was whether the Rider provided for a series of substantially equal periodic payments.

The Internal Revenue Code does not define what constitutes as substantially equal periodic payments. However, the phrase is used in Section 72(q)(2)(D). Section 72(q)(2)(D) described substantially equal periodic payments as a distribution “made for the life of the taxpayer or over a period extending for at least 60 months after the annuity starting date”<sup>77</sup> Revenue Ruling 2002-62 (citing IRS Notice 89-25) provides three methods that satisfy the substantially equal periodic payments for Section 72(q)(2)(D), which are: (1) the required minimum distribution method based upon the applicable prescribed mortality table; (2) the fixed amortization method, which is based on amortizing the account balance over level payments for a specified number of years; and (3) the fixed annuitization method, which is based on dividing the account balance by an annuity factor determined under the applicable prescribed mortality table and chosen interest rate.

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77 PLR 200818018

Based on prior IRS rulings, the IRS found that if a variable annuity contract utilizes a methodology “under which substantially the same number of annuity units is withdrawn to make each periodic payment” then such contract provides for substantially equal periodic payments. Additionally, a method that replicated the effects of an approved calculation would result in substantially equal periodic payments.

The IRS concluded that the method Lincoln’s i4LIFE® Advantage rider uses to calculate periodic payments has the same effect as the methods listed in the previous ruling and, therefore, provides substantially equal periodic payments. Therefore, inasmuch as the i4LIFE® Advantage rider was described in this Private Letter Ruling, the IRS has approved its use by Lincoln.

#### *Summary of the Private Letter Rulings*

The above Private Letter Rulings provided permission by the IRS for the intended application of the Lincoln i4LIFE® Advantage rider. Private Letter Ruling 200305018 provided that periodic payments received under the contract will qualify for the annuity exclusion ratio, and will therefore afford the tax-deferred benefits of annuity contracts. The Private Letter Ruling also determined that the availability of the surrender feature does not result in the recognition of income. Furthermore, the rider’s availability and options in relation to choosing the length of the Access Period will not result in the recognition of ordinary income by the taxpayer, because changing the length of the Access Period does not change the exclusion ratio. Private Letter Ruling 200818018 provided that the i4LIFE® Advantage rider constitutes an immediate annuity and qualifies for the immediate annuity exception to the 10% excise tax.

#### **The i4LIFE® Advantage and the Inheritance Rules**

As discussed in the beginning of this Chapter, the i4LIFE® Advantage rider allows the policyholder to maintain control of investments under a variable annuity contract while receiving annual payments based on annuitization factors with a guaranteed lifetime cash flow. The following discussion addresses the general rules applicable to the distribution of annuity contracts after death, and how the i4LIFE® Advantage rider provides a mechanism to “stretch” tax-deferral under these rules.

Section 72(s)(1)(B) provides that if the owner of an annuity contract dies before the annuity starting date, the entire interest in the contract must be distributed within 5 years of the death of the owner. Section 72(s)(1)(A) provides a different scheme where an annuity is inherited after the annuity starting date. So long as the annuity contract requires the carrier to continue payments in a manner “at least as rapidly” as they were being made to the holder of the contract, payments can continue to be made to the designated beneficiary. In other words, if a period certain was part of the annuitization terms, that period certain cannot be extended and a younger life cannot be substituted for the annuitant.

Where an annuitant dies under an annuitized contract and the payment rights extend for a “period certain” after death, then if the investment in the contract has not been completely returned to the annuitant during his or her lifetime, the first payments made to the beneficiary will be tax-free until the holder’s investment in the contract is recovered (a “first-in, first-out”, or “FIFO” basis). For this purpose the beneficiary is defined to be whoever is receiving payments after the death of the annuitant, which could be the original owner.

Section 72(s)(1)(A) does not reference whether the beneficiary must be an individual, or whether a trust can be named as a beneficiary and still be able to receive annuity payments “at least as rapidly” as the holder of the contract had been receiving them before his or her death. The rules of Section 72(u) cause a loss of tax deferral when a non-natural person holds an annuity contract (other than an immediate annuity) unless it is holding the annuity as an agent for a natural person. The IRS has ruled that trusts holding annuity contracts on behalf of beneficiaries may be permitted to retain tax deferral under the theory that the trust is holding the contract as a “nominee” of the applicable beneficiary. The rulings in this area should be carefully reviewed and may be applied narrowly by the Internal Revenue Service to require a separate dedicated annuity contract for each individual beneficiary and other structuring and provisions that should be carefully approached. Oftentimes Private Letter Rulings will be recommended for any trust that is taxed as an entity separate and apart from its Grantor or a beneficiary.

Section 72(s)(2) provides an exception to the 5 year rule on the death of the holder of a deferred annuity. The inheritance rules give the beneficiary the option of: (1) taking a lump sum; (2) deferring payments for up to 5 years, if the holder dies before the annuity start date; or (3) spreading the payments out over the beneficiary’s life expectancy.<sup>78</sup> It is unclear whether the third option is available where a trust held for the benefit of one or more individual “designated beneficiaries” is made the beneficiary of the contract. These limited options make deferred annuity contracts unattractive from an inheritance planning standpoint, but the ability to stretch distributions and to spray the stretched income to lower tax bracket beneficiaries alleviates the problem, if the annuity contract is made payable directly to an individual beneficiary.

Jackson National Life Insurance Company obtained Private Letter Ruling 200151038 in 2001, which permitted a non-spousal beneficiary to receive his non-qualified annuity inheritance over his life expectancy under the same rules for stretching an IRA payment (known as the “conventional stretch”).

Despite this improvement, family asset transfer planning remains less than optimal because the annuity pays out over the life expectancy of the selected beneficiary. If the annuity was left to a child and that child lived to his life expectancy, then there will be nothing left for the grandchildren. If the asset was left to the grandchildren, the children would be disinherited. Generally, grandparents want to leave their assets in a way that benefits all of their family members, but the deferred annuity beneficiary distribution rules do not facilitate this planning technique. For planning with retirement plans or IRAs, this is typically accomplished by making the retirement plan or IRA payable to a trust established for the benefit of multiple generations whereby the trust will receive annual distributions from the plan or IRA based upon the life expectancy of the oldest beneficiary of the trust. However, it is unclear whether the tax advantages of this strategy apply in the context of non-qualified annuity contracts.

A second problem with the conventional stretch approach is the distribution of cash flow. The stretch payments begin rather small so that the tax-deferred growth stores up income that becomes a “tax time bomb” down the road as the required payments become larger.

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<sup>78</sup> Section 72(s)(3) indicates another exception which provides that if the designated beneficiary of the contract is the surviving spouse, then the spouse is treated as the owner of the contract. The surviving spouse can therefore continue to take distributions under the contract on a tax-deferred basis as if he or she were the original owner of the contract.



The conventional stretch is available under most annuity contracts, and is illustrated by the following example:

Assume that Junior is the beneficiary of an annuity that he inherited from his father, Frank, who died when Junior was age 49. The annuity contract has a death benefit feature that allows a designated beneficiary to be named by the holder, and provides for the payment of the annuity contract account balance over the life expectancy of the designated beneficiary. The life expectancy factor on a non-recalculated life expectancy in the year following death, Junior's age 50, would be 34.2. This is the divisor that is used to divide into the prior year's account balance to determine the Required Minimum Distribution for the year. If the account balance was \$1,000,000 at the end of the year of Frank's death, the Required Minimum Distribution would be 2.9239% of \$1,000,000 (\$29,239, which is  $1/34.2$ ). The next year the distribution would be 3.01205% of the end of the year account balance ( $34.2-1=33.2$ .  $1/33.2=.0301205$  or 3.1205%). If we subtract one each year, the annuity would be totally depleted by age 84, 35 years after Junior inherited the annuity. ( $34.2-34=0.2$ ;  $1/0.2=5$ , which would require distribution of the entire account.) Junior can apply Frank's unrecovered basis (i.e., Frank's investment in the contract that has not been returned to him in the form of the tax-free portion of any annuity payments received during his lifetime).

Conversely, if Frank left the annuity to a trust to care for Junior and his children, the only safe options available to the trustee would be to elect either the lump sum distribution or the 5 year payment option.

The stretch option for non-spouse beneficiaries of non-annuitized annuities is an improvement over the lump sum or 5 year options, but from a wealth transfer planning perspective, it leaves much to be desired because of the lack of certainty surrounding naming a trust the beneficiary of annuity death benefits.

Under the Lincoln i4LIFE<sup>®</sup> Advantage rider and with many other commercial annuities there can be two annuitants, if a joint life payment is desired. Also, the period during which periodic payments are made to the annuitant can be extended until the younger annuitant reaches age 115. With these building blocks, the "dynasty stretch" can be constructed using the i4LIFE<sup>®</sup> Advantage rider.

The following is an example of how this mechanism works:

Using the parties in the example above, Frank is the owner of a \$1,000,000 Lincoln contract with the i4LIFE<sup>®</sup> Advantage rider. He names his 5 year old grandson, Greg, as the annuitant and he set the Access Period at 110 years; Greg's age 115. Frank dies immediately after naming Junior his beneficiary. The underlying investments will earn 7%, which is not reflective of any actual investment but is used strictly for the purpose of illustrating this concept. Using a lower or higher assumed interest rate allows the contract to have either more income or more tax deferral if the guaranteed income benefit is not included.

Junior's first payment is \$40,854 of which \$4,535 is tax-free. This is slightly higher than the \$29,239 required payment under the stretch example above. However, the i4LIFE<sup>®</sup> Advantage payments increase less rapidly than the conventional stretch payments do under these assumptions. After 8 years, the withdrawal from the

conventional stretch exceeds the i4LIFE® Advantage payment by \$1,082 (\$46,953 versus \$45,871). From this point forward, the i4LIFE® Advantage payments are smaller than the conventional stretch, with the exception of the final payment in Year 35 when the conventional stretch takes a final small payment, exhausting the account. In Year 30, when the conventional stretch payment breaks \$200,000 (\$208,019), the dynasty stretch was only \$84,275. Since less money is distributed, the account can continue to grow and accumulate a larger tax-deferred balance. For example, at Year 30 the tax-deferred balance in the conventional stretch program is \$934,838, while the dynasty stretch under the i4LIFE® Advantage tax-deferred balance has grown to \$2,072,430.

If Junior were to die at age 85 when the conventional stretch terminates, there is nothing left in the annuity for Greg. However, with the dynasty stretch program, Greg inherits a contract that is still tax-deferred, has a payment that generates an exclusion ratio of \$4,535 per year, has an annual income of \$97,412, and has a guaranteed minimum income benefit of \$73,059. By year 80, Greg's age 85, his income has grown to \$416,152 including a guaranteed income benefit of \$312,114 and the account balance has reached \$7,220,026.

If Greg dies, the guaranteed minimum income benefit will die with him. According to Section 72(e)(5)(E) and Treasury Regulation 1.72-11, the exclusion ratio is replaced with a FIFO payment scheme. This last change is minor because the remaining investment in the contract is only \$136,050. Junior can leave this contract to his daughter, Debbie, who was not born when this example began. Debbie then has all of the benefits, except for the guaranteed income benefit. The contract runs for another 30 years at which time the last payment drains the account, either for the benefit of Debbie or one of her heirs. Over the 110 year life of the contract, \$33,939,480 has been distributed as compared with \$4,100,366 over the 35 year life of the conventional stretch, more than 8 times as much.

The smaller payments in the early years of the dynasty stretch permit the contract to build faster than under the conventional stretch. This also means that Junior receives less benefit. However, Junior has an account value he can draw from if he wants to. Frank may think this is good or bad, depending on whether he believes Junior is responsible. If Frank wants to prevent discretionary access, he can name a trust as the beneficiary and the various benefits would flow to the trust to be used for the benefit of Junior and his heirs. If a deferred contract had been left to a trust, the conventional stretch is not an option because the trust does not provide a measuring life.

The dynasty stretch that is available with the i4LIFE® Advantage rider offers several potential advantages over the conventional stretch method. First, the dynasty stretch approach can be structured to pay out less than the conventional stretch, allowing more tax-deferred growth. Second, the payments can be guaranteed on one or two younger lives, with the flexibility that the payments do not need to be based on the life of the recipient. Third, a lifetime income guarantee in the form of the guaranteed minimum income benefit can be made available. Fourth, flexibility is enhanced since the i4LIFE® Advantage requires a smaller payment stream, but has an Access Period that allows for the withdrawal of money. Finally, the benefits can be passed to a trust, unlike a conventional stretch.

## **Challenges Facing Unmarried Couples, Siblings and Friends**

Individuals who want to benefit non-spouse beneficiaries, such as significant others, siblings and friends, face the same retirement income challenges as married individuals. However, they are not afforded the same tax and legal protections. A wealthy individual may face challenges if he or she wants to give assets or income to a less wealthy significant other, sibling or friend, given the lack of free transferability between unmarried individuals. In particular, the following challenges apply:

1. They cannot file jointly to share deductions or take advantage of tax credits, capital losses, or other characteristics that would apply to married couples.
2. At the death of an individual, a surviving non-spouse beneficiary is not permitted to use the spousal beneficiary exception under Section 72(s). The non-spouse beneficiary is subject to the 5-year rule, unless he or she is the designated beneficiary under the contract and can use the designated beneficiary exception.
3. Annuity contracts typically only allow income guarantees to married couples. However, some carriers are beginning to allow income guarantees to unmarried couples or to non-spouses designated by the contract owner.

When a contract annuitizes prior to the death of the holder, Section 72(s)(1)(A) controls. This Section provides that if the entire interest has not been distributed, then the post-death distribution must continue “at least as rapidly” as it was on the date of the holder’s death. When the annuitization is based on a life or period certain and the annuitant dies, the exclusion ratio is replaced with a FIFO payment scheme so that the first payments made will be tax-free to the extent of the holder’s unrecovered investment in the contract. Although these rules permit deferral for the benefit of a non-spouse beneficiary, the traditional downsides of annuitization have prevented widespread use of these contracts for individuals with non-spouse partners.

Lincoln’s i4LIFE® Advantage rider allows the contract holder to maintain control of the account balance within the annuity and to make unscheduled withdrawals from the account.

Example 1: John and Joseph have been partners for 8 years, but they have not gotten married under the laws of a state that permits same-sex marriage. They want to plan for their retirement and want any excess assets to go to their adopted son, Robert. John is in a higher tax bracket and has more assets than Joseph. John uses some of his lifetime gift exemption to fund a Lincoln annuity in Joseph’s name. Both John and Joseph have i4LIFE® measuring lives. John is named as the primary beneficiary and a trust for Robert is designated as the contingent beneficiary. While Joseph is alive, the payments are made to him as the owner and he pays the taxes in his lower tax bracket. So long as either John or Joseph is alive, the income is guaranteed. After Joseph’s death, the residual value may be paid to John. The residuary balance can be paid to the trust for Robert on a FIFO basis and is enjoyed over the remaining Access Period.

Example 2: Mary and Martha are sisters entering retirement. Neither of them have children. Mary wants to take care of Martha in retirement and wants any residual to go to her brother, Mike’s, children (her nieces and nephews). Mary buys the Lincoln annuity and designates herself and Martha as the measuring lives. She names a trust for her nieces and nephews as a contingent beneficiary. The terms of the trust are to provide for Martha and then to distribute trust assets to the nieces and nephews.

Retirement income is guaranteed so long as either Mary or Martha is alive. If Mary dies first, Martha's needs will be satisfied, but she cannot change the residual beneficiaries.

Because the Lincoln annuity with the i4LIFE® Advantage rider overcomes the objections to traditional annuitization, it opens the door to more widespread use of the annuitization rules for individuals who want to benefit non-spouse beneficiaries. The enhanced flexibility permits income guarantees for domestic partners and other non-spouse beneficiaries while allowing for a variety of tax and legacy concerns.

### **The i4LIFE® Advantage Rider Conclusion**

Although complex and not inexpensive, the i4LIFE® Advantage features provided by Lincoln Financial Group have distinct and unique tax planning advantages that should be understood and considered by advisors who are helping clients select investment contracts. However, the i4LIFE® Advantage rider provides a flexible alternative to the traditional deferred annuity to allow for basis allocation among payments, and avoidance of the 10% excise tax in many situations. It is therefore a planning tool that should be understood, and used when appropriate.

## **CHAPTER 13**

### **SAMPLE CLIENT LETTER**

The following “sample client letter” explains variable annuity proposals while comparing products from three separate carriers, guarantee features, and the possibility of exchanging growth in value for long-term care insurance using Code Section 2035.

The non-commissioned low cost carrier and the normal cost carrier both offered “income guarantee” features that the client had an interest in.

The client’s objective was to invest approximately \$150,000 in a safe arrangement that would yield approximately \$7,500 a year that could be used to pay for long-term insurance, thinking that all of the income would in effect be tax-free because of the ability to have a 1035 exchange of \$7,500 a year worth of the annuity holdings into a long-term care contract under Internal Revenue Code Section 1035. If the income guarantee would assure that the \$7,500 a year would be produced in addition to the principal being protected, this could be tax-free, which made the arrangement seem very attractive.

Unfortunately, the result of our analysis showed that these expectations could not be assured, and that the tax treatment was not as favorable as first thought by the agent and the client. The tax treatment is described in Chapter 4 with reference to only a small portion of the income being considered as passing from the annuity contract to the long-term care contract, as therein described.

John B. Smith  
1234 Variable Lane  
Annuity, FL 12345

Dear John:

I think we have finally pulled together and described the alternatives on the variable annuity investment situation.

#### **Carrier 1 Introduction**

We started off with the Carrier 1 product which would cost 3.44% per year in average internal charges, which includes a 1% per year charge for having the Highest Daily Lifetime Income Guarantee. However, the fine print states that Carrier 1 reserves the right to increase the 1% annual charge to a maximum of 2%, at any time in the future.

The Carrier 1 product also includes certain fees and expenses if you decide to withdraw or transfer the funds that you have invested into the annuity. Carrier 1 calls these investments “Purchase Payments.” Attempting to surrender the annuity, to take partial withdrawals, or to transfer Account Value between the investment options will result in additional fees, which are deducted from the Purchase Payment you are withdrawing. The fees are based on a percentage that is determined by the age of the Payment that was made into the Annuity. The older the Payment into the annuity, the less it costs to surrender. The percentages are shown in Table A, which is at the end of this letter.

First, it is important to note that the Carrier 1 product has two different “account balances” that are used to determine value and minimum payments.

The first is the “Actual Account Value,” which is the amount or amounts that you put into the contract, minus expenses, adjusted for market performance, and reduced by any and all payments you receive from the product. The value of this account can be withdrawn or surrendered at any time; however, the money you withdraw or surrender is susceptible to additional fees and expenses.

The second is the “Protected Withdrawal Value,” and it is basically an artificial calculated amount that is used to calculate your minimum annual payment. While the Protected Withdrawal Value will never lose its artificial value by reason of negative market performance during a given year, it is not available as cash or a lump sum withdrawal amount. For purposes of this letter, we are going to call this the “Phantom Payment Reference Value.”

The Phantom Payment Reference Value is simply multiplied by the payment percentage described below to determine your minimum annual payment.

A simple example can help show how these two different “accounts” work. If you put \$100,000 into this product and elect to begin taking “guaranteed payments” based upon 5.00% (which would apply if you begin payments between ages 70 and 84), then any payments that you receive reduce the “Actual Account Value,” but leave your Phantom Payment Reference Value fixed.

The exact percentages and the corresponding ages that the guaranteed payments are based upon are as follows:

- 3.00% for ages 50-54;
- 3.50% for ages 55 to less than 59 ½;
- 4.00% for ages 59 ½ to 64;
- 4.50% for ages 65-69;
- 5.00% for ages 70- 84; and
- 6.00% for ages 85 or older.

It is important to note that the percentage selected above will be fixed for the entire length of the contract based upon when you elect to receive your first annual payment. The percentage does not go up if and when you reach a later age shown above.

Therefore, while your Actual Account Value may go to zero because of bad investment results, annuity expenses, and the reduction for payments, the Phantom Payment Reference Value can be substantially more than the Actual Account Value, so that the annual payments remain the same or increase, notwithstanding that there may be no money actually left in the Actual Account Value, and nothing to pass on in the event of your death.

For further clarification on the differences between these two accounts, see Table B, Actual Account Value vs. The Phantom Payment Reference Value, at the end of this letter.

### **Carrier 1 Guarantee Feature**

The Highest Daily Lifetime Income guarantee feature mentioned in the Carrier 1 product literature simply means that the Phantom Payment Reference Value for each year will be no less than the highest actual account value for the year and will appreciate at 5.00% annually. The Phantom Payment Reference Value will appreciate at 5.00% annually until whichever of the following occur first: (1) the contract exceeds 10 years; or (2) you take your first lifetime withdrawal.

**Example 1:**

Tom invests \$100,000 in an annuity on day one. As the result of positive market performance during the first year, Tom's annuity has reached a highest daily account value of \$140,000. After adding the 5.00% guaranteed annual compounded growth rate, Tom's Phantom Payment Reference Value will be \$147,000 ( $\$140,000 \times 1.05 = \$147,000$ ), while his Actual Account Balance will remain at \$140,000.

Tom plans on making his initial annual income withdrawal immediately. When Tom takes his initial annual income amount, two things will happen: (1) Tom's 5.00% guaranteed annual compounded growth rate will no longer apply to his Phantom Payment Reference Value; and (2) Tom will trigger his minimum annual payments and rights, whereby the applicable payment percentage (based upon his age), will be multiplied by his Phantom Payment Reference Value to determine his minimum annual payments. If Tom is 70 when he takes his initial minimum annual payment, he will receive 5.00% of \$147,000 for life ( $\$147,000 \times 0.05 = \$7,350$ ). Tom's Actual Account Value will only be \$140,000 because the additional 5.00% guaranteed annual growth rate only applies to his Phantom Payment Reference Value. Once the annual payment is made to Tom, his Actual Account Balance will be reduced to reflect the annual payment he received minus any contract fees that apply.

If in year two Tom's Actual Account Balance is reduced because of negative market conditions, he can continue to receive the minimum annual payments that are based on his Phantom Payment Reference Value and not his Actual Account Value, which could fall to zero.

Following the same example above, the Highest Daily Lifetime Income guarantee offers another unique feature called the Highest Daily Auto Step-Up. This feature facilitates a larger Phantom Payment Reference Value. If market conditions cause positive fluctuations in Tom's Actual Account Value, and result in a highest daily account value that is larger than his current Phantom Payment Reference Value, Carrier 1 replaces the existing amount with the new, higher amount. When Tom's Phantom Payment Reference Value increases, his minimum annual payment also increases. Thus, Tom's Phantom Payment Reference Value and annual payments will never decrease as a result of negative market conditions.

Remember, once you have taken your first lifetime withdrawal, your investment will no longer be guaranteed to increase by at least 5.00%, and instead your Phantom Payment Reference Value will reflect your highest daily value since your highest performance year while you continue to take payments out. Your Phantom Payment Reference Value will never fall lower than your highest daily value as a result of negative market conditions, but it may increase as a result of positive market conditions.

**Example 2:**

Tom, a 65 year-old male, purchases a Carrier 1 variable annuity with the Highest Daily Lifetime Income Guaranty of \$150,000 from his savings account. If Tom waits 5 years to take his first lifetime withdrawal, the \$150,000 in the phantom account will grow annually at a minimum of 5.00%, while his Actual Account will fluctuate with the market each year. When Tom reaches 70 and elects to make his first lifetime withdrawal, his Phantom Payment Reference Value will be at least \$191,442.23 (this is \$150,000 compounded annually for 5 years at 5.00%). Since Tom is between 70 and 84 when he begins to take his payments, the minimum annual payment will be 5.00% of the Phantom Payment Reference Value, or in this case 5.00% of \$191,442.23 ( $\$191,442.23 \times 0.05 = \$9,572.11$ ). In order to exceed a 5.00% rate of return, with a 3.44% annual expense amount, the 70%/30% equity/bond mix of investments would have to exceed an 8.44% rate of return in each given

year, which will certainly not be expected to occur in every year. Also, it is important to remember that once Tom takes his first lifetime withdrawal, or after the first 10 years of owning the annuity, whichever occurs first, his Phantom Payment Reference Value will remain stable, but will not go up, because he will be withdrawing 5% per year. Tom's annual withdrawals will remain the same except to the extent that positive market conditions (exceeding 8.44% in each given year) cause his Phantom Payment Reference Value to increase. Tom's Actual Account Value could go to zero and the Highest Daily Lifetime Guarantee will nevertheless ensure that Tom receives a withdrawal amount for the remainder of his life based on his Phantom Payment Reference Value.

This would be a much more attractive product if you could withdraw the amount of the "cash value," but the product only allows you to withdraw the actual value you chose to annuitize and not any guaranteed value that is used to determine the guaranteed payment (such as the Phantom Account Value).

### **Carrier 2 Variable Annuity Product**

We also looked at the Carrier 2 Variable Annuity product.

When we started looking at this product it had a 1.56% per year total minimum expense based upon 0.95% being paid for the Guaranteed Lifetime Withdrawal feature and 0.61% being paid for the annuity base. This changed recently to 1.20% for the Guaranteed Lifetime Withdrawal Benefit, and we have illustrated the new cost, which would now be based upon a total of 1.76 % per year if you want the guarantee feature.

The Carrier 2 product would cost on average approximately 0.56% per year without the guaranteed lifetime withdrawal feature.

A Carrier 2 representative has reviewed this letter and let us know that our description here as to the Carrier 2 product is accurate. He also let us know that based upon his generalized understanding of the Carrier 1 product, without reviewing Carrier 1 literature or otherwise, that our explanation above seems accurate.

The Carrier 2 Guarantee Lifetime Withdrawal Base is similar to the Carrier 1 arrangement, to the extent that there is an artificial phantom amount that is tracked based upon what you put into the contract, plus market increases each year, and without reduction for market decreases during a negative year. Carrier 2 calls this account the "Total Withdrawal Base." This Total Withdrawal Base amount is multiplied by 5.00% (or whichever percentage is applicable based on your age when you take your initial annual withdrawal) to determine what your annual withdrawal is notwithstanding whether the actual account value goes to below zero.

### **Example 3:**

Tom invests \$150,000 into a Carrier 2 Variable Annuity and he elects to pay for the single life Guaranteed Lifetime Withdrawal Benefit. Tom chooses to start his withdrawals at the age of 65. At age 65, Tom is guaranteed to receive at least 5.00% of \$150,000, or \$7,500, a year for life if he does not take excess withdrawals. Taking excess withdrawals beyond the maximum annual withdrawal amount will reduce or eliminate the income and the guarantee provided by the product Tom elected to purchase on a pro rata basis.



If Tom waited until he was 80 or older to take his first lifetime withdrawal, he would be guaranteed an annual withdrawal equivalent to 6.00% of the Total Withdrawal Base. The Total Withdrawal Base is affected by market returns, but it will never go below Tom's initial investment value and it will also lock in at the highest attained value to reflect positive market conditions.

The difference between the Carrier 2 Guarantee and the Carrier 1 Guarantee is that with the Carrier 1 product, Tom receives a 5.00% minimum step-up on the Phantom Payment Reference Value if he begins to take withdrawals, or if the contract is within the first 10 years since it was purchased, whichever occurs first; Carrier 2 does not have this feature. However, while Carrier 1 has surrender charges as shown below, the Carrier 2 Variable Annuity has no surrender charges, which apply to impose a charge of up to 5% if a surrender occurs within the first 7 years. I would note that up to 10% of the contract value can be surrendered each year from inception without being subject to the surrender charges.

### **Carrier 3 Product**

We looked at the Carrier 3 product which has a Guaranteed Income Fund (GIF) option.

We are not able to understand the Carrier 3 guarantee and costs, but we think that the cost of the internal mutual funds and the administrative fees equate to 1.25% on average.

The actual policy language for the guarantee is attached, and quite frankly is indiscernible.

### **Charts**

We ran some charts to show the impact on the value of one annuity purchased for \$150,000, from which there would be an annual "tax-free exchange" to pay for long-term care insurance of \$7,500 per year.

The Chart A series (available upon request) show all three products with and without the income guarantees, with the exception of Carrier 3 which we did not show with a guarantee. Each chart assumes that the investment accounts held under each product have a 7.00% rate of return, and are then reduced by the applicable annual costs described above.

Each product, with and without the guarantee, has its own chart.

There is also one comparison chart showing how each product compares with the other given assumptions as stated on the chart.

The comparison chart (available upon request) shows that Carrier 2 is green, Carrier 2 Guarantee is dark blue, Carrier 1 is red, Carrier 1 Guarantee is light blue, and Carrier 3 is orange. Under this scenario, Carrier 2's product without the guarantee performs the best.

The Chart B series (available upon request) is based upon the same assumptions, but with a 5.00% rate of return. Here again, the Carrier 2 product without the guarantee offers the best performance.

The Chart C series (available upon request) shows the same assumptions, but with a 30.00% loss of value in year one, a 20.00% loss of value in year two, and no further growth or losses.

Assuming a 70% equities and 30% bond mix, and that bonds would not lose their value in a market crash, the 70% equities would have to lose 42.86% of their value to have the portfolio lose 30% of its value in year one. If the portfolio lost 20% of its value in year two, the equities would have lost 35.00% of their value, as shown in the following chart:

<b>Year</b>	<b>Bonds</b>	<b>Stocks</b>	<b>Total Investment</b>	<b>Loss of Portfolio</b>	<b>Loss of Equities</b>
1	\$30,000	\$70,000	\$100,000	--	--
2	\$30,000	\$40,000	\$70,000	-30.00%	-42.86%
3	\$30,000	\$26,000	\$56,000	-20.00%	-35.00%
			Total Loss	-50.00%	-77.86%

The chart under Tab 25 (available upon request) shows that all three annuities would lapse within 10 years if you decided to take out \$7,500 per year and do not purchase any guarantees.

If you choose to pay extra for the guarantees, the annuities would continue to pay out on two of the policies, Carrier 1 and Carrier 2, for the remainder of your lifetime at applicable percentages.

Looking at these charts, I believe that if I had to choose between the choices above, I would go with Carrier 2 to have an extra \$17,055 in the contract than what would be available under the Carrier 3 contract, and to have an extra \$47,162 more than Carrier 1 after 10 years.

Looking at the chart under Tab 26 (available upon request), which is the worst case scenario that we show, the Carrier 1 product with the guarantee performs better than the other products after 12 years. However, after 25 years, it is still only \$53,565 higher than the Carrier 2 product with the guarantee.

We also ran numbers to demonstrate what portion of the contract would remain as taxable if contract values were used to purchase long-term care insurance. At first one would think that all of the income held under the variable annuity would first be applied to the long-term care contract, but that is not the way it works. Instead a “vertical slice” is taken. For example, if the contract is worth \$100,000 and has \$10,000 of income in it, then if \$10,000 is taken out and transferred tax-free into a long-term care contract, this carries out \$1,000 of the income and the remaining \$90,000 annuity contract has \$9,000 of unrecognized income and \$91,000 of principal remaining.

We ran two scenarios at Tab 29 (available upon request), one with a rate of return at 7%, and the other at a 5% rate of returns. Under the illustration showing the 7% rate of return, after 10 years the amount of income stored up in the contract that will be subject to income tax when eventually distributed will be \$124,303.17, which is 52.49% of the value!

Therefore, if the contract performs well it becomes a “ticking time bomb” as far as eventually having ordinary income come out to the children and/or grandchildren, or trusts for their benefit after you and Susie have passed away.

**Rankings**

So how do these products rank up to one another given the assumptions we have taken into consideration?

**If Internal Investments Grow at 7% & Payments are Initiated After 1 Year**

<b>Ranking</b>	<b>Variable Annuity</b>	<b>Cumulative Withdrawals</b>	<b>End of Year Account Balance</b>	<b>Total:\$150,000 after 25 years, assuming 7% Growth</b>	<b>Rate of Return</b>
1st	Carrier 2	\$187,500	\$283,360	\$470,860	6.40%
2nd	Carrier 3	\$180,625	\$272,970	\$453,595	6.11%
3rd	Carrier 2 Guaranteed	\$210,891	\$139,841	\$350,731	5.12%
4th	Carrier 1	\$187,500	\$129,050	\$316,550	4.39%
5th	Carrier 1 Guaranteed	\$217,648	\$19,533	\$237,182	3.32%

**If Internal Investments Grow at 5.00% & Payments are Initiated After 1 Year**

<b>Ranking</b>	<b>Variable Annuity</b>	<b>Cumulative Withdrawals</b>	<b>End of Year Account Balance</b>	<b>Total:\$150,000 after 25 years, assuming 5.00% Growth</b>	<b>Rate of Return</b>
1st	Carrier 2	\$187,500	\$130,637	\$318,137	4.41%
2nd	Carrier 3	\$187,500	\$111,633	\$299,133	4.13%
3rd	Carrier 2 Guaranteed	\$203,081	\$33,984	\$237,064	3.15%
4th	Carrier 1	\$187,500	\$26,459	\$213,959	2.44%
				\$209,588	2.54%

**If Internal Investments have a 30% Loss in Year 1, 20% Loss in Year 2, and Do Not Have Additional Growth Thereafter and Payments are Initiated After the First Year**

<b>Ranking</b>	<b>Variable Annuity</b>	<b>Cumulative Withdrawals</b>	<b>End of Year Account Balance</b>	<b>Total:\$150,000 after 25 years, assuming a Loss</b>	<b>Rate of Return</b>
1st	Carrier 1 Guaranteed	\$196,875	\$0	\$206,719	2.43%
2nd	Carrier 2 Guaranteed	\$187,500	\$0	\$187,500	1.66%
3rd	Carrier 2	\$80,797	\$0	\$80,797	-8.12%
4th	Carrier 3	\$79,345	\$0	\$79,345	-8.45
5th	Carrier 1	\$71,735	\$0	\$71,735	-10.41%

**If Internal Investments Grow at 7% & Payments are Initiated After 5 Years**

<b>Ranking</b>	<b>Variable Annuity</b>	<b>Cumulative Withdrawals</b>	<b>End of Year Account Balance</b>	<b>Total:\$150,000 after 25 years, assuming 7% Growth</b>	<b>Rate of Return</b>
1st	Carrier 2	\$157,500	\$438,745	\$596,245	6.40%
2nd	Carrier 3	\$157,500	\$397,587	\$555,087	6.11%
3rd	Carrier 2 Guaranteed	\$216,284	\$176,263	\$392,547	5.12%
4th	Carrier 1	\$157,500	\$208,004	\$365,504	4.39%
5th	Carrier 1 Guaranteed	\$208,333	\$56,130	\$264,463	3.32%

**If Internal Investments Grow at 5.00% & Payments are Initiated After 5 Years**

<b>Ranking</b>	<b>Variable Annuity</b>	<b>Cumulative Withdrawals</b>	<b>End of Year Account Balance</b>	<b>Total:\$150,000 after 25 years, assuming 5.00% Growth</b>	<b>Rate of Return</b>
1st	Carrier 2	\$157,500	\$209,981	\$367,481	4.41%
2nd	Carrier 3	\$157,500	\$186,257	\$343,757	4.13%
3rd	Carrier 2 Guaranteed	\$193,134	\$68,045	\$261,179	3.15%
4th	Carrier 1	\$157,500	\$78,0595	\$235,559	2.44%
5th	Carrier 1 Guaranteed	\$186,034	\$381	\$186,415	1.39%

**If Internal Investments have a 30% Loss in Year 1, 20% Loss in Year 2, and Do Not Have Additional Growth Thereafter and Payments are Initiated After 5 Years**

<b>Ranking</b>	<b>Variable Annuity</b>	<b>Cumulative Withdrawals</b>	<b>End of Year Account Balance</b>	<b>Total:\$150,000 after 25 years, assuming a Loss</b>	<b>Rate of Return</b>
1st	Carrier 1 Guaranteed	\$211,065	\$0	\$211,065	2.21%
2nd	Carrier 2 Guaranteed	\$157,500	\$0	\$157,500	0.31%
3rd	Carrier 2	\$79,053	\$0	\$79,053	-5.63%
4th	Carrier 3	\$76,853	\$0	\$76,853	-5.95%
5th	Carrier 1	\$65,667	\$0	\$65,667	-7.82%

**Table A: Carrier 1 Surrender Fees:**

The monies that are exchanged for the rights, privileges, and benefits of the annuity you purchase are susceptible to additional fees and expenses if the annuity is surrendered, you take partial withdrawals, or you transfer account value between investment options.

The fees are based on a percentage that is determined by the age of the payment that was made into the annuity.

<b>Age of Payment into the Annuity</b>	<b>Percentage Applied Against the money you decide to surrender, withdraw, or transfer</b>
Less than 1 year old	7.0%
Less than 2 years old	7.0%
Less than 3 years old	6.0%
Less than 4 years old	6.0%
Less than 5 years old	5.0%
Less than 6 years old	5.0%
Less than 7 years old	5.0%
7 years old or greater	0.0%

**Table B: Actual Account Value vs. the Phantom Payment Reference Value**

	<b>Actual Account</b>	<b>Phantom Account</b>
Increased By	<ol style="list-style-type: none"> <li>1. Cash Put In</li> <li>2. Income and appreciation from funds if positive</li> </ol>	<ol style="list-style-type: none"> <li>1. Cash Put In</li> <li>2. Income and appreciation from funds if greater than previous Phantom Value (Step-ups)</li> <li>3. Prejudicial Guarantee Only – Highest Daily Lifetime Value appreciates at 5.00% annually if contract is in first 10 years or there has yet to be an initial lifetime withdrawal, whichever occurs first</li> </ol>
Reduced By	<ol style="list-style-type: none"> <li>1. Cash Pulled Out</li> <li>2. Guaranteed Annual Withdrawals</li> <li>3. Expenses and Fees</li> <li>4. Negative Market Conditions and any surrender charges</li> </ol>	<ol style="list-style-type: none"> <li>1. Withdrawals in excess of the annual guaranteed payment</li> <li>2. Otherwise, guarantees ensure that this value remains fixed and can only increase as a reflection of positive market adjustments. Thus, increasing annual payments</li> </ol>
Effect	Available for withdrawal at any time, subject to any surrender charges (for Prejudicial) if applicable	<ol style="list-style-type: none"> <li>1. Not available for withdrawal – this is simply a reference value that is multiplied by an applicable percentage to determine minimum annual payments that can be withdrawn</li> <li>2. Withdrawals cannot exceed the guaranteed percentage described above</li> </ol>

After running the analysis we have discussed, we know that if returns are good, a guaranteed withdrawal benefit is a disadvantage because of the costs associated with the guarantee. If returns are bad, the Guaranteed Lifetime Withdrawal benefit is an advantage because it is possible that your Actual Account Value could go to zero while you would still receive payments with a guarantee. If you let your payment for the annuity sit for a few years prior to taking payments, you may receive larger annual payments once you take your initial withdrawal because your guaranteed withdrawal base may have grown larger over time, depending on the market.

Further, the Carrier 1 product is most advantageous to have if you delay taking payments out in the first years and when negative market conditions cause your initial investment to suffer a loss; the product's guaranteed 5.00% annual growth allows your Phantom Payment Reference Value balance to continue to grow while your Actual Account Balance may decline. As a result, your guaranteed payments will increase while the market negatively affects your Actual Account Balance. A variable annuity with a guaranteed income benefit would be beneficial to an investor that is pessimistic about the stock market and who is mostly concerned with receiving a guaranteed income stream, rather than having funds left over for his or her heirs when he or she passes away.

This is very much an art and not a science, so please let me know your questions, comments, and suggestions for this analysis.

Best personal regards,  
Alan S. Gassman

**CHAPTER 14**

**CHART COMPARING PRIVATE LETTER RULINGS  
REGARDING TRUSTS AS ANNUITY OWNERS**

<b>Private Letter Ruling</b>	<b>Facts</b>	<b>Representations</b>	<b>Holding</b>	<b>Was the Trust a Natural Person?</b>
9120024 (1991)	<p>*A will enter into a security agreement with Associates, a seller of pre-need funeral arrangements. Under the security agreement Associates will, with funds received from A, create an irrevocable trust, the trust, with Trustee/Bank.</p> <p>*There is NO personal or family relationship between or among any of the parties to the transaction. (emphasis added)</p> <p>*Pursuant to the security agreement and the trust agreement the Trustee/Bank will manage and invest the funds as Associates deems fit.</p> <p>*Trustee/Bank will be the nominal owner of the annuity contracts. A will be the beneficiary of the Trust.</p> <p>*Trust will accumulate and not be disbursed until the death of A.</p> <p>*Trustee/Bank shall disburse the funds in the following order of priority:</p> <ol style="list-style-type: none"> <li>1) to the funeral director who has actually delivered services or merchandise;</li> <li>2) to any person who has paid for such services or merchandise;</li> <li>3) to A or his personal representative; or</li> <li>4) (in the case of A's default) to Associates.</li> </ol> <p>Associates is required by the law of State to place the funds received under the security agreement into an account with a financial institution, Trustee/Bank, for the</p>	<p>The legislative history of Section 72(u) shows that Congress intended where a non-natural person (e.g., a corporation or trust) is a nominal owner of an annuity, but the beneficial owner is a natural person, the annuity is treated as held by a natural person.</p>	<p>If the arrangement is an annuity, that the trust holds the annuity contract(s) as an agent for a natural person within the meaning of Section 72(u)(1) of the Code, because the trust holds the annuity contract(s) as an agent for A, a natural person, for purposes of section 72(u)(1).</p>	YES



Private Letter Ruling	Facts	Representations	Holding	Was the Trust a Natural Person?
	protection of A.			
9120024 (1991) (Cont'd)	<p>*Associates, therefore, has no dominion and control over the funds. Trust is the entity Associates is utilizing to meet the statutory requirement.</p> <p>*Once in trust, disposition of the money reflects the wishes of A more than those of Associates.</p> <p>*Therefore, A is treated for Federal income tax purposes as the grantor of trust with respect to his contract payments.</p>			
9204010 (1992)	<p>*Trust was established by H, W and Trustee. Trust named D as its sole beneficiary and H as its trustee.</p> <p>*Subsequent to the original establishment date, Trustee was named as the trustee.</p> <p>*Trust purchased Annuity Contract, a deferred variable annuity contract, from a life insurance company.</p> <p>*Annuity Contract named D as the annuitant and Trustee as the contract owner.</p> <p>*The provisions of trust provide that Trustee may pay income or corpus, or both, to D, until D attains the age of 40 at which time Trustee must deliver the entire corpus of the trust, including Annuity Contract, to D.</p> <p>*Trustee will not receive any consideration from D in exchange for the distribution of Annuity Contract.</p> <p>*Annuity Contract will be distributed to D prior to its annuity starting date.</p>	<p>A) D is a natural person as that term is used in Section 72(u) of the Code.</p> <p>B) H and W, the grantors of trust, will not be considered the owners of trust for purposes of Sections 671-679 of the Code.</p>	<p>1) Annuity Contract is considered owned by a natural person for purposes of Section 72(u)(1) of the Code.</p> <p>2) The distribution of Annuity Contract by trust to D will not be treated as an assignment of an annuity contract without full and adequate consideration under Section 72(e)(4)(C).</p>	YES
9639057 (1996)	<p>*A, an individual, is interested in purchasing an "annuity contract" through a "trust" arrangement established by X with Y as</p>	<p>A) It is readily apparent that Y is acting as an agent for A. Y's duties are limited to</p>	<p>Provided that the proposed transaction described above is not being utilized</p>	YES

Private Letter Ruling	Facts	Representations	Holding	Was the Trust a Natural Person?
	<p>trustee.</p> <p>*X is a corporation engaged in the marketing of both insurance products and investment company products to customers of financial institutions.</p> <p>*Y is a financial institution. X will pay all of Y's fees for acting as "trustee" under the arrangement.</p> <p>*X also will establish and maintain records and perform other necessary services as agent for the trust.</p> <p>Pursuant to a participation agreement, A will transfer funds to Y.</p> <p>*At A's direction, Y will use the funds to purchase an annuity contract specified by A from an unrelated insurance company.</p> <p>*The contract will be issued to Y, which will hold the contract for A's sole benefit.</p> <p>*A will exercise control over the annuity contract in the same manner as if legal title to the contract were directly held by A.</p> <p>*Y's duties with regard to the contract will be limited to receiving contributions from A, forwarding those contributions at A's direction to the insurance company as consideration for the issuance of an annuity contract selected by A, and holding title to the annuity contract for A's sole benefit. At any time, A may terminate participation in the arrangement and direct Y to distribute the annuity contract to A.</p>	<p>receiving contributions from A, forwarding those contributions at A's direction to an unrelated insurance company as consideration for the issuance of an annuity contract selected by A, and holding legal title to the contract for A's sole benefit.</p> <p>B) A alone will have the power to designate beneficiaries or otherwise to exercise control over the annuity contract. Except as directed by A, Y will be unable to exercise any rights under the annuity contract.</p> <p>C) Finally, A may terminate participation in the arrangement at any time and direct Y to distribute the annuity contract to A.</p>	<p>to fund a non-qualified deferred compensation arrangement, we conclude that the annuity contract will be held by Y as agent for A and, therefore, Section 72(u)(1) will not preclude treating the contract as an annuity contract for tax purposes.</p>	
199905015 (1999)	<p>*Decedent created Trust, which became irrevocable at Decedent's death.</p> <p>*Trustee is directed to make a</p>	<p>A) C, D and E are natural persons as that term is used in section 72(u).</p>	<p>1) The three G annuity contracts are considered owned by natural</p>	<p>YES</p>

Private Letter Ruling	Facts	Representations	Holding	Was the Trust a Natural Person?
	<p>nominal distribution to X each year.</p> <p>*The primary beneficiaries of trust are C, D and E.</p> <p>*Trust accumulates its income (after the nominal distribution to X) and principal for distribution on the date H years after the death.</p> <p>*On that date, the entire trust estate will be distributed equally to C, D and E.</p> <p>*Trust purchased three F single premium deferred annuities with trust as owner and beneficiary and C, D and E, respectively, as the annuitant.</p> <p>*These contracts were purchased in order to permit tax deferral on the growth of the investment in the contracts.</p> <p>*The three F single premium deferred annuities were exchanged for three G annuity contracts pursuant to Internal Revenue Code Section 1035.</p> <p>*One G contract names C as annuitant, one names D as annuitant and one names E as annuitant.</p> <p>*At termination, the contracts are to be distributed to the named annuitants C, D and E, respectively, as beneficiaries of trust.</p>	<p>B) Decedent, the settlor of trust, will not be considered the owner of trust for purposes of Sections 671-679.</p> <p>C) C, D and E are not employed by Trust or any entity held by Trust.</p> <p>D) The three G annuity contracts satisfy the terms of Section 72(s).</p> <p>E) Under no circumstances will Trust distribute the three G annuity contracts to anyone other than C, D and E.</p>	<p>persons for purposes of Section 72(u).</p> <p>2) The distribution of the three G annuity contracts by Trust to C, D and E, respectively, will not be treated as an assignment of an annuity contract without full and adequate consideration under Section 72(e)(4)(C).</p>	
199933033 (1999)	<p>*Trustee of initial trust and wife want to give a trust to their son.</p> <p>*Trust was established as a complex, irrevocable trust.</p> <p>*Grantors will contribute cash and purchase deferred annuity from commercial life insurance company.</p> <p>*Trust will continue for son's lifetime and terminate on death.</p> <p>*If son has heirs, subtrusts</p>	<p>A) Son is a natural person as the term is used in Section 72(u).</p> <p>B) The Grantors of Trust are not considered to be the owners of Trust for purposes of Section 671-679.</p> <p>C) The annuity</p>	<p>Annuity Contract held by Trust is considered owned by a natural person for purpose of Section 72(u).</p>	YES

Private Letter Ruling	Facts	Representations	Holding	Was the Trust a Natural Person?
	<p>will be created.</p> <p>*If son dies without heirs, property will be distributed to relatives of grantors or son.</p> <p>*Initial Trustee or successor trustee, once annuity contract is purchased, will have power to select annuitization options.</p> <p>*Son has special power of appointment by will or separate document (if old enough) of all or any part of the property in the trust based on:</p> <ol style="list-style-type: none"> <li>1. Blood</li> <li>2. Marriage</li> <li>3. Adoption</li> </ol>	<p>contract at issue satisfies the terms of Section 72(s).</p> <p>D) Under no circumstances will Trust distribute the annuity contract to anyone other than Son or his descendants or relatives of Son or Grantors. All of these contingent beneficiaries will be natural persons.</p>		
200449016 (2004)	<p>*Settlor established a trust for sole benefit of his grandchild and made a single cash gift.</p> <p>*Trustee invested entire cash gift in a single premium annuity issued by Life Insurer 1.</p> <p>*Trustee then made a Section 1035 Transaction and exchanged the annuity for another in from Life Insurer 2.</p> <p>*Annuity contract names the trust as owner and the beneficiary as annuitant.</p> <p>*Beneficiary can request distribution of funds at age(s) 30, 35, and 40 for the amounts of 25%, 33.5% and 100% respectively.</p> <p>*Should beneficiary not request any distributions, trustee must hold the portion of the principal over which beneficiary has power of withdrawal in a separate trust for sole benefit of beneficiary.</p> <p>*Trust will receive no consideration from beneficiary, or any other individual or entity, in exchange for any distributions</p>	<p>A) Each beneficiary is a natural person as that term is defined in Section 72(u).</p> <p>B) Settlor as the grantor of trust will not be considered the owner of trust for purposes of Sections 671-679.</p> <p>C) Beneficiary is not employed by trust.</p> <p>D) Any annuity contracts involved satisfy the terms of Section 72(s)</p> <p>E) Under no circumstance will trust distribute any of the annuity contracts described in this request to anyone other than beneficiary, or other than to the separate trust, described above,</p>	<p>The annuity contract is considered owned by a natural person for purposes of Section 72(u)(1) of the Code.</p>	YES

Private Letter Ruling	Facts	Representations	Holding	Was the Trust a Natural Person?
	of the annuity.	for beneficiary's sole benefit, if beneficiary is living. If beneficiary dies prior to attaining age 40, the distribution will be made to beneficiary's issue, or, if beneficiary dies without issue, the distribution will be made to or for the benefit of persons related to beneficiary.		
200626034 (2006)	<p>*Settlor established irrevocable Trust in year 1.</p> <p>* Settlor did not retain the right to alter, amend, revoke, or terminate Trust or any provision within.</p> <p>*Furthermore, settlor did not retain any right, title, or interest in the income or the principal of the trust and no right, title or interest incident of ownership</p> <p>*Neither settlor nor estate had a reversionary interest in Trust or Trust property.</p> <p>*During settlor's lifetime, trustee had no power to make distributions from trust.</p> <p>*In year 3, Trust purchased an annuity (Old Annuity) from an Insurance Company</p> <p>*Trust is owner and beneficiary of Old Annuity.</p> <p>*Son of the settlor is the annuitant. (beneficiary A)</p> <p>*Year 9, Old Annuity is exchanged for a new deferred annuity (New Annuity) which was issued by Insurance Company in a Section 1035 Exchange.</p> <p>*Trust remained the owner and beneficiary of the New Annuity.</p>	<p>A) The trust has not and will not receive any consideration from a beneficiary, or any other individual or entity in exchange for any distributions with respect to the annuities to a beneficiary.</p> <p>B) Each beneficiary is a natural person as that term is defined in Section 72(u).</p> <p>C) Settlor of Trust was not considered the owner of the Trust for Purposes of Sections 671-679.</p> <p>D) None of the beneficiaries are employed by the trust.</p> <p>E) Any annuity contracts involved satisfy the terms of Section 72(s).</p>	Old Annuity and New Annuity are considered owned by a natural person for purposes of Section 72(u)(1) of the Code.	YES

Private Letter Ruling	Facts	Representations	Holding	Was the Trust a Natural Person?
	<p>*Beneficiary A was still the annuitant; Beneficiaries A, B, C and D remained primary beneficiaries of the trust.</p> <p>*Settlor dies in Year 14, trustee was to divide Trust property into equal shares for the children of Settlor then living. Each share set aside in a separate trust.</p> <p>*Beneficiaries elected to remove their share of principal in the Trust; all that remained in the Trust was the New Annuity</p> <p>Annuity will be surrendered in year 16 and distributed to children (A,B,C, and D)</p>	<p>F) Under no circumstances has Trust made or will make any distributions with respect to Old Annuity and New Annuity to anyone other than beneficial owners of Old Annuity and New Annuity</p>		
201124008 (2011)	<p>*Prior to death, H established Trust as a grantor trust.</p> <p>*The named beneficiaries were W and A, B, C, D, E, and F (“Beneficiaries”), the descendants of H and W.</p> <p>*During H’s life, H and W were co-trustees. H died. Upon H’s death, W became sole trustee and Trust was divided into three sub-trusts:</p> <p>*Trust A was allocated an amount based on the allowed exemption and marital deduction for Federal estate tax purposes.</p> <p>*Trust C was allocated an amount based on the exemption from the Federal Estate Tax provided the amount was not used for the payment of taxes, debts, or administration expenses of H’s estate.</p> <p>*Once all taxes, debts, and expenses have been paid, the assets of Trust C are to be distributed to Trust B.</p> <p>*During the life of W, trustee may in its discretion pay or use the property of Trust B for the benefit of W, and others partly or wholly</p>	<p>A) The annuity contracts are owned by a trust under which all the beneficial interests are owned by natural persons in a non-employment context. Accordingly, the contracts will be treated as being owned by a natural person for purposes of Section 72(u)(1).</p> <p>B) the transfer of the contracts from the Trust to the Beneficiaries does not have the effect of avoiding the required distribution rules of Section 72(s); the annuitant is not changed. Accordingly, the distribution of the contracts from Trust to Beneficiaries will not be treated as an</p>	<p>1. The Annuity Contracts are considered owned by natural persons for purposes of Section 72(u).</p> <p>2. The distribution of the Annuity Contracts by the Trust to the Beneficiaries will not be treated as an assignment of an annuity contract without full and adequate consideration under Section 72(e)(4)(C).</p>	YES

<b>Private Letter Ruling</b>	<b>Facts</b>	<b>Representations</b>	<b>Holding</b>	<b>Was the Trust a Natural Person?</b>
	<p>dependent upon W, to maintain the standard of living which W enjoyed prior to H's death, and for the support and education of descendants and others dependent upon W. At W's death, the property of Trust B is to be divided and distributed among Beneficiaries A, B, C, D, E, and F in the proportions stated in Trust.</p> <p>*Trustee intends to purchase flexible premium deferred annuity contracts (Annuity Contracts), naming each of Beneficiaries A, B, C, D, E, and</p> <p>*F as the annuitant on one Annuity Contract, in proportion to each Beneficiary's residuary share of Trust.</p> <p>*Trust will be the owner and beneficiary of the Annuity Contracts during the life of W.</p> <p>*Upon final distribution of Trust, each Beneficiary will be distributed the Annuity Contract for which that Beneficiary is the annuitant.</p>	<p>assignment of an annuity contract without full and adequate consideration under Section 72(e)(4)(C).</p>		

## CHAPTER 15

### RELEVANT INTERNAL REVENUE CODE SECTIONS

#### 72(a) General rules for annuities

##### **(1) Income inclusion**

Except as otherwise provided in this chapter, gross income includes any amount received as an annuity (whether for a period certain or during one or more lives) under an annuity, endowment, or life insurance contract.

##### **(2) Partial annuitization**

If any amount is received as an annuity for a period of 10 years or more or during one or more lives under any portion of an annuity, endowment, or life insurance contract—

(A) such portion shall be treated as a separate contract for purposes of this section,

(B) for purposes of applying subsections (b), (c), and (e), the investment in the contract shall be allocated pro rata between each portion of the contract from which amounts are received as an annuity and the portion of the contract from which amounts are not received as an annuity, and

(C) a separate annuity starting date under subsection (c)(4) shall be determined with respect to each portion of the contract from which amounts are received as an annuity.

#### 72(b) Exclusion ratio

##### **(1) In general**

Gross income does not include that part of any amount received as an annuity under an annuity, endowment, or life insurance contract which bears the same ratio to such amount as the investment in the contract (as of the annuity starting date) bears to the expected return under the contract (as of such date).

##### **(2) Exclusion limited to investment**

The portion of any amount received as an annuity which is excluded from gross income under paragraph (1) shall not exceed the unrecovered investment in the contract immediately before the receipt of such amount.

##### **(3) Deduction where annuity payments cease before entire investment recovered**

(A) In general

If—

(i) after the annuity starting date, payments as an annuity under the contract cease by reason of the death of an annuitant, and

(ii) as of the date of such cessation, there is unrecovered investment in the contract, the amount of such unrecovered investment (in excess of any amount specified in subsection (e)(5) which was not included in gross income) shall be allowed as a deduction to the annuitant for his last taxable year.

(B) Payments to other persons

In the case of any contract which provides for payments meeting the requirements of subparagraphs (B) and (C) of subsection (c)(2), the deduction under subparagraph (A) shall be allowed to the person entitled to such payments for the taxable year in which such payments are received.

(C) Net operating loss deductions provided

For purposes of section 172, a deduction allowed under this paragraph shall be treated as if it were attributable to a trade or business of the taxpayer.

##### **(4) Unrecovered investment**

For purposes of this subsection, the unrecovered investment in the contract as of any date is—

(A) the investment in the contract (determined without regard to subsection (c)(2)) as of the annuity starting date, reduced by



(B) the aggregate amount received under the contract on or after such annuity starting date and before the date as of which the determination is being made, to the extent such amount was excludable from gross income under this subtitle.

#### 72(c) Definitions

##### **(1) Investment in the contract**

For purposes of subsection (b), the investment in the contract as of the annuity starting date is—

(A) the aggregate amount of premiums or other consideration paid for the contract, minus

(B) the aggregate amount received under the contract before such date, to the extent that such amount was excludable from gross income under this subtitle or prior income tax laws.

##### **(2) Adjustment in investment where there is refund feature**

If—

(A) the expected return under the contract depends in whole or in part on the life expectancy of one or more individuals;

(B) the contract provides for payments to be made to a beneficiary (or to the estate of an annuitant) on or after the death of the annuitant or annuitants; and

(C) such payments are in the nature of a refund of the consideration paid, then the value (computed without discount for interest) of such payments on the annuity starting date shall be subtracted from the amount determined under paragraph (1). Such value shall be computed in accordance with actuarial tables prescribed by the Secretary. For purposes of this paragraph and of subsection (e)(2)(A), the term “refund of the consideration paid” includes amounts payable after the death of an annuitant by reason of a provision in the contract for a life annuity with minimum period of payments certain, but (if part of the consideration was contributed by an employer) does not include that part of any payment to a beneficiary (or to the estate of the annuitant) which is not attributable to the consideration paid by the employee for the contract as determined under paragraph (1)(A).

##### **(3) Expected return**

For purposes of subsection (b), the expected return under the contract shall be determined as follows:

(A) Life expectancy

If the expected return under the contract, for the period on and after the annuity starting date, depends in whole or in part on the life expectancy of one or more individuals, the expected return shall be computed with reference to actuarial tables prescribed by the Secretary.

(B) Installment payments

If subparagraph (A) does not apply, the expected return is the aggregate of the amounts receivable under the contract as an annuity.

##### **(4) Annuity starting date**

For purposes of this section, the annuity starting date in the case of any contract is the first day of the first period for which an amount is received as an annuity under the contract; except that if such date was before January 1, 1954, then the annuity starting date is January 1, 1954.

#### 72(e) Amounts not received as annuities

(1) Application of subsection

(A) In general

This subsection shall apply to any amount which—

(i) is received under an annuity, endowment, or life insurance contract, and

(ii) is not received as an annuity, if no provision of this subtitle (other than this subsection) applies with respect to such amount.

(B) Dividends

For purposes of this section, any amount received which is in the nature of a dividend or similar distribution shall be treated as an amount not received as an annuity.

(2) General rule

Any amount to which this subsection applies—

(A) if received on or after the annuity starting date, shall be included in gross income, or

(B) if received before the annuity starting date—

(i) shall be included in gross income to the extent allocable to income on the contract, and

(ii) shall not be included in gross income to the extent allocable to the investment in the contract.

(3) Allocation of amounts to income and investment

For purposes of paragraph (2)(B)—

(A) Allocation to income

Any amount to which this subsection applies shall be treated as allocable to income on the contract to the extent that such amount does not exceed the excess (if any) of—

(i) the cash value of the contract (determined without regard to any surrender charge) immediately before the amount is received, over

(ii) the investment in the contract at such time.

(B) Allocation to investment

Any amount to which this subsection applies shall be treated as allocable to investment in the contract to the extent that such amount is not allocated to income under subparagraph (A).

(4) Special rules for application of paragraph (2)(B)

For purposes of paragraph (2)(B)—

(A) Loans treated as distributions

If, during any taxable year, an individual—

(i) receives (directly or indirectly) any amount as a loan under any contract to which this subsection applies, or

(ii) assigns or pledges (or agrees to assign or pledge) any portion of the value of any such contract, such amount or portion shall be treated as received under the contract as an amount not received as an annuity. The preceding sentence shall not apply for purposes of determining investment in the contract, except that the investment in the contract shall be increased by any amount included in gross income by reason of the amount treated as received under the preceding sentence.

(B) Treatment of policyholder dividends

Any amount described in paragraph (1)(B) shall not be included in gross income under paragraph (2)(B)(i) to the extent such amount is retained by the insurer as a premium or other consideration paid for the contract.

(C) Treatment of transfers without adequate consideration

(i) In general, if an individual who holds an annuity contract transfers it without full and adequate consideration, such individual shall be treated as receiving an amount equal to the excess of—

(I) the cash surrender value of such contract at the time of transfer, over

(II) the investment in such contract at such time, under the contract as an amount not received as an annuity.

(ii) Exception for certain transfers between spouses or former spouses Clause (i) shall not apply to any transfer to which section 1041 (a) (relating to transfers of property between spouses or incident to divorce) applies.

(iii) Adjustment to investment in contract of transferee If under clause (i) an amount is included in the gross income of the transferor of an annuity contract, the investment in the contract of the transferee in such contract shall be increased by the amount so included.

(5) Retention of existing rules in certain cases

(A) In general

In any case to which this paragraph applies—

(i) paragraphs (2)(B) and (4)(A) shall not apply, and

(ii) if paragraph (2)(A) does not apply, the amount shall be included in gross income, but only to the extent it exceeds the investment in the contract.

(B) Existing contracts

This paragraph shall apply to contracts entered into before August 14, 1982. Any amount allocable to investment in the contract after August 13, 1982, shall be treated as from a contract entered into after such date.

(C) Certain life insurance and endowment contracts

Except as provided in paragraph (10) and except to the extent prescribed by the Secretary by regulations, this paragraph shall apply to any amount not received as an annuity which is received under a life insurance or endowment contract.

(D) Contracts under qualified plans

Except as provided in paragraph (8), this paragraph shall apply to any amount received—

(i) from a trust described in section 401 (a) which is exempt from tax under section 501 (a),

(ii) from a contract—

(I) purchased by a trust described in clause (i),

(II) purchased as part of a plan described in section 403 (a),

(III) described in section 403 (b), or

(IV) provided for employees of a life insurance company under a plan described in section 818 (a)(3), or

(iii) from an individual retirement account or an individual retirement annuity.

Any dividend described in section 404 (k) which is received by a participant or beneficiary shall, for purposes of this subparagraph, be treated as paid under a separate contract to which clause (ii)(I) applies.

(E) Full refunds, surrenders, redemptions, and maturities

This paragraph shall apply to—

(i) any amount received, whether in a single sum or otherwise, under a contract in full discharge of the obligation under the contract which is in the nature of a refund of the consideration paid for the contract, and

(ii) any amount received under a contract on its complete surrender, redemption, or maturity.

In the case of any amount to which the preceding sentence applies, the rule of paragraph (2)(A) shall not apply.

(6) Investment in the contract

For purposes of this subsection, the investment in the contract as of any date is—

(A) the aggregate amount of premiums or other consideration paid for the contract before such date, minus

(B) the aggregate amount received under the contract before such date, to the extent that such amount was excludable from gross income under this subtitle or prior income tax laws.

(7) Repealed. Pub. L. 100-647, title I, § 1011A(b)(9)(A), Nov. 10, 1988, 102 Stat. 3474

(8) Extension of paragraph (2)(b) 1 to qualified plans

(9) Extension of paragraph (2)(B) to qualified tuition programs and Coverdell education savings accounts

(10) Treatment of modified endowment contracts

(11) Special rules for certain combination contracts providing long-term care insurance

Notwithstanding paragraphs (2), (5)(C), and (10), in the case of any charge against the cash value of an annuity contract or the cash surrender value of a life insurance contract made as payment for coverage under a qualified long-term care insurance contract which is part of or a rider on such annuity or life insurance contract—

(A) the investment in the contract shall be reduced (but not below zero) by such charge, and

(B) such charge shall not be includible in gross income.

(12) Anti-abuse rules

(A) In general

For purposes of determining the amount includible in gross income under this subsection—

(i) all modified endowment contracts issued by the same company to the same policyholder during any calendar year shall be treated as 1 modified endowment contract, and

(ii) all annuity contracts issued by the same company to the same policyholder during any calendar year shall be treated as 1 annuity contract.

The preceding sentence shall not apply to any contract described in paragraph (5)(D).

(B) Regulatory authority

The Secretary may by regulations prescribe such additional rules as may be necessary or appropriate to prevent avoidance of the purposes of this subsection through serial purchases of contracts or otherwise.

72(q) 10-percent penalty for premature distributions from annuity contracts

(1) Imposition of penalty

If any taxpayer receives any amount under an annuity contract, the taxpayer's tax under this chapter for the taxable year in which such amount is received shall be increased by an amount equal to 10 percent of the portion of such amount which is includible in gross income.

(2) Subsection not to apply to certain distributions

Paragraph 1 shall not apply to any distribution—

(A) made on or after the date on which the taxpayer attains age 59 1/2,

(B) made on or after the death of the holder (or, where the holder is not an individual, the death of the primary annuitant (as defined in subsection (s)(6)(B))),

(C) attributable to the taxpayer's becoming disabled within the meaning of subsection (m)(7),

(D) which is a part of a series of substantially equal periodic payments (not less frequently than annually) made for the life (or life expectancy) of the taxpayer or the joint lives (or joint life expectancies) of such taxpayer and his designated beneficiary,

(E) from a plan, contract, account, trust, or annuity described in subsection (e)(5)(D),

(F) allocable to investment in the contract before August 14, 1982, or [2]

(G) under a qualified funding asset (within the meaning of section 130 (d), but without regard to whether there is a qualified assignment),

(H) to which subsection (t) applies (without regard to paragraph (2) thereof),

(I) under an immediate annuity contract (within the meaning of section 72 (u)(4)), or

(J) which is purchased by an employer upon the termination of a plan described in section 401 (a) or 403 (a) and which is held by the employer until such time as the employee separates from service.

(3) Change in substantially equal payments

If—

(A) paragraph (1) does not apply to a distribution by reason of paragraph (2)(D), and

(B) the series of payments under such paragraph are subsequently modified (other than by reason of death or disability)—

(i) before the close of the 5-year period beginning on the date of the first payment and after the taxpayer attains age 59 1/2, or

(ii) before the taxpayer attains age 59 1/2, the taxpayer's tax for the 1st taxable year in which such modification occurs shall be increased by an amount, determined under regulations, equal to the tax which (but for paragraph (2)(D)) would have been imposed, plus interest for the deferral period (within the meaning of subsection (t)(4)(B)).

72(s) Required distributions where holder dies before entire interest is distributed

(1) In general

A contract shall not be treated as an annuity contract for purposes of this title unless it provides that—

(A) if any holder of such contract dies on or after the annuity starting date and before the entire interest in such contract has been distributed, the remaining portion of such interest will be distributed at least as rapidly as under the method of distributions being used as of the date of his death, and

(B) if any holder of such contract dies before the annuity starting date, the entire interest in such contract will be distributed within 5 years after the death of such holder.

(2) Exception for certain amounts payable over life of beneficiary

If—

(A) any portion of the holder's interest is payable to (or for the benefit of) a designated beneficiary,

(B) such portion will be distributed (in accordance with regulations) over the life of such designated beneficiary (or over a period not extending beyond the life expectancy of such beneficiary), and

(C) such distributions begin not later than 1 year after the date of the holder's death or such later date as the Secretary may by regulations prescribe, then for purposes of paragraph (1), the portion referred to in subparagraph (A) shall be treated as distributed on the day on which such distributions begin.

(3) Special rule where surviving spouse beneficiary

If the designated beneficiary referred to in paragraph (2)(A) is the surviving spouse of the holder of the contract, paragraphs (1) and (2) shall be applied by treating such spouse as the holder of such contract.

(4) Designated beneficiary

For purposes of this subsection, the term "designated beneficiary" means any individual designated a beneficiary by the holder of the contract.

(5) Exception for certain annuity contracts

This subsection shall not apply to any annuity contract—

(A) which is provided—

(i) under a plan described in section 401 (a) which includes a trust exempt from tax under section 501, or

(ii) under a plan described in section 403 (a),

(B) which is described in section 403 (b),

(C) which is an individual retirement annuity or provided under an individual retirement account or annuity, or

(D) which is a qualified funding asset (as defined in section 130 (d), but without regard to whether there is a qualified assignment).

(6) Special rule where holder is corporation or other non-individual

(A) In general

For purposes of this subsection, if the holder of the contract is not an individual, the primary annuitant shall be treated as the holder of the contract.

(B) Primary annuitant

For purposes of subparagraph (A), the term "primary annuitant" means the individual, the events in the life of whom are of primary importance in affecting the timing or amount of the payout under the contract.

(7) Treatment of changes in primary annuitant where holder of contract is not an individual

For purposes of this subsection, in the case of a holder of an annuity contract which is not an individual, if there is a change in a primary annuitant (as defined in paragraph (6)(B)), such change shall be treated as the death of the holder.

72(u) Treatment of annuity contracts not held by natural persons

(1) In general

If any annuity contract is held by a person who is not a natural person—

(A) such contract shall not be treated as an annuity contract for purposes of this subtitle (other than subchapter L), and

(B) the income on the contract for any taxable year of the policyholder shall be treated as ordinary income received or accrued by the owner during such taxable year.

For purposes of this paragraph, holding by a trust or other entity as an agent for a natural person shall not be taken into account.

(2) Income on the contract

(A) In general

For purposes of paragraph (1), the term “income on the contract” means, with respect to any taxable year of the policyholder, the excess of—

(i) the sum of the net surrender value of the contract as of the close of the taxable year plus all distributions under the contract received during the taxable year or any prior taxable year, reduced by

(ii) the sum of the amount of net premiums under the contract for the taxable year and prior taxable years and amounts includible in gross income for prior taxable years with respect to such contract under this subsection.

Where necessary to prevent the avoidance of this subsection, the Secretary may substitute “fair market value of the contract” for “net surrender value of the contract” each place it appears in the preceding sentence.

(B) Net premiums

For purposes of this paragraph, the term “net premiums” means the amount of premiums paid under the contract reduced by any policyholder dividends.

(3) Exceptions

This subsection shall not apply to any annuity contract which—

(A) is acquired by the estate of a decedent by reason of the death of the decedent,

(B) is held under a plan described in section 401 (a) or 403 (a), under a program described in section 403 (b), or under an individual retirement plan,

(C) is a qualified funding asset (as defined in section 130 (d), but without regard to whether there is a qualified assignment),

(D) is purchased by an employer upon the termination of a plan described in section 401 (a) or 403 (a) and is held by the employer until all amounts under such contract are distributed to the employee for whom such contract was purchased or the employee’s beneficiary, or

(E) is an immediate annuity.

(4) Immediate annuity

For purposes of this subsection, the term “immediate annuity” means an annuity—

(A) which is purchased with a single premium or annuity consideration,

(B) the annuity starting date (as defined in subsection (c)(4)) of which commences no later than 1 year from the date of the purchase of the annuity, and

(C) which provides for a series of substantially equal periodic payments (to be made not less frequently than annually) during the annuity period.

1035 – Certain exchanges of insurance policies

(a) General rules

No gain or loss shall be recognized on the exchange of—

(1) a contract of life insurance for another contract of life insurance or for an endowment or annuity contract or for a qualified long-term care insurance contract;

(2) a contract of endowment insurance;

(A) for another contract of endowment insurance which provides for regular payments beginning at a date not later than the date payments would have begun under the contract exchanged, or

(B) for an annuity contract, or

(C) for a qualified long-term care insurance contract;

(3) an annuity contract for an annuity contract or for a qualified long-term care insurance contract; or

(4) a qualified long-term care insurance contract for a qualified long-term care insurance contract.

(b) Definitions

For the purpose of this section—

(1) Endowment contract

A contract of endowment insurance is a contract with an insurance company which depends in part on the life expectancy of the insured, but which may be payable in full in a single payment during his life.

(2) Annuity contract

An annuity contract is a contract to which paragraph (1) applies but which may be payable during the life of the annuitant only in installments. For purposes of the preceding sentence, a contract shall not fail to be treated as an annuity contract solely because a qualified long-term care insurance contract is a part of or a rider on such contract.

(3) Life insurance contract

A contract of life insurance is a contract to which paragraph (1) applies but which is not ordinarily payable in full during the life of the insured. For purposes of the preceding sentence, a contract shall not fail to be treated as a life insurance contract solely because a qualified long-term care insurance contract is a part of or a rider on such contract.

(c) Exchanges involving foreign persons

To the extent provided in regulations, subsection (a) shall not apply to any exchange having the effect of transferring property to any person other than a United States person.

(d) Cross references

(1) For rules relating to recognition of gain or loss where an exchange is not solely in kind, see subsections (b) and (c) of section 1031.

(2) For rules relating to the basis of property acquired in an exchange described in subsection (a), see subsection (d) of section 1031.

Part III

Administrative, Procedural & Miscellaneous

Section 1035

(Also § 72)

## Rev. Proc. 2011-38

### SECTION 1. PURPOSE

This revenue procedure addresses the tax treatment of certain tax-free exchanges of annuity contracts under § 72 and § 1035 of the Internal Revenue Code. Rev. Proc. 2008-24, 2008-1 C.B. 684, is modified and superseded.

### SECTION 2. BACKGROUND

01 Section 1035(a)(3) provides that no gain or loss shall be recognized on the exchange of an annuity contract for another annuity contract. The legislative history of § 1035 states that exchange treatment is appropriate for “individuals who have merely exchanged one insurance policy for another better suited to their needs.” H.R. Rep. No. 1337, 83d Cong., 2d Sess. 81 (1954). Section 1.1035-1 of the Income Tax Regulations provides that “the exchange, without recognition of gain or loss, of an annuity contract for another annuity contract under § 1035(a)(3) is limited to cases where the same person or persons are the obligee or obligees under the contract received in the exchange as under the original contract.”

02 If, in addition to an annuity contract, a taxpayer receives other property or money in exchange for a second annuity contract, then gain (if any) is recognized to the extent of the sum of money and the fair market value of other property received, but loss (if any) is not recognized to any extent. Section 1035(d)(1) (cross referencing § 1031(b) and (c)); § 1.1031(b)-1(a); § 1031(c)-1.

03 Section 72(e) governs the federal tax treatment of any amount received under an annuity contract that is not received as an annuity if no other income tax provision applies with respect to such amount. Under § 72(e)(2), such amounts generally are taxed on an income-first basis. Section 72(e)(12) provides that all annuity contracts issued by the same company to the same policyholder during any calendar year are treated as a single annuity contract for purposes of § 72(e).

04 In *Conway v. Commissioner*, 111 T.C. 350 (1998), acq., 1999-2 C.B. xvi, the Tax Court held that the direct exchange by an insurance company of a portion of an existing annuity contract to an unrelated insurance company for a new annuity contract was a tax-free exchange under § 1035. Such a transaction is sometimes referred to as a “partial exchange.” See also Rev. Rul. 2007-24, 2007-21 I.R.B. 1282 (receipt of a check under a nonqualified annuity contract and endorsement of the check to a second company as consideration for a second annuity contract treated as a distribution under § 72(e), rather than as a tax-free exchange under § 1035); Rev. Rul. 2002-75, 2002-2 C.B. 812 (assignment of an entire annuity contract for deposit into a preexisting annuity contract treated as a tax-free exchange under § 1035).

05 In Rev. Rul. 2003-76, 2003-2 C.B. 355, a taxpayer directly transferred a portion of the cash surrender value of an existing annuity contract (the original contract) for a new contract issued by a second insurance company. The ruling concludes that the transfer was a tax-free exchange under § 1035, and that the basis and investment in the contract for the original contract immediately before the exchange was required to be allocated ratably between the original contract and the new contract based on the percentage of the cash value transferred to purchase the new contract.

06 Rev. Proc. 2008-24 set forth circumstances under which a direct transfer of a portion of the cash surrender value of an existing annuity contract for a second annuity contract would be treated as a tax-free exchange under



1035. Under the revenue procedure, a transfer was treated as a tax-free exchange if no amount was withdrawn from, or received in surrender of, either of the contracts involved in the exchange during the 12 months beginning on the date of the transfer, or if the taxpayer demonstrated that one of the conditions described by § 72(q)(2)(A), (B), (C), (E), (F), (G), (H), or (J) or any similar life event “occurred between” the date of the transfer and the date of the withdrawal or surrender. A transfer within the scope of Rev. Proc. 2008-24 that was not treated as a tax-free exchange under § 1035 was instead treated as a taxable distribution under § 72(e), followed by a payment for the second contract. Rev. Proc. 2008-24 superseded interim guidance provided by Notice 2003-51, 2003-2 C.B. 362.

07 Section 2113 of the Small Business Jobs Act, P.L. 111-240, added § 72(a)(2) of the Internal Revenue Code to provide rules for the partial annuitization of a single annuity contract. Section 72(a)(2) provides that, if any amount is received as an annuity for 10 years or more or during one or more lives under any portion of an annuity, endowment or life insurance contract-- (a) that portion is treated as a separate contract for purposes of § 72; (b) the investment in the contract generally is allocated pro rata between each portion of the contract from which amounts are received as an annuity and the portion from which amounts are not so received; and (c) a separate annuity starting date is determined with respect to each portion of the contract from which amounts are received as an annuity. The amendment applies to amounts received in taxable years beginning after December 31, 2010.

08 Since 2008, Treasury and the Service have learned of several practical issues that diminish the effectiveness of Rev. Proc. 2008-24. For example, some taxpayers have commented that it is not clear how the “occurred between” standard should be applied with regard to several of the conditions that are enumerated in § 72(q)(2) or to similar life events. Other taxpayers have commented that the alternative characterization of a transfer that does not qualify as a tax-free exchange is unclear, and that a 12-month waiting period produces administrative difficulties in some situations where an income tax return already was filed for the year in which the transfer took place. Still others have argued that Treasury and the Service should provide relief for payments received as an annuity under an annuity contract involved in a partial exchange. As a result of the recent amendment of § 72(a), a taxpayer may partially annuitize a single annuity contract and apply an exclusion ratio, rather than the income-first rule of § 72(e), to amounts received as an annuity under the annuitized portion of the contract.

09 Treasury and the Service have determined that it is in the interest of sound tax administration to modify the guidance provided by Rev. Proc. 2008-24 to address these issues. Accordingly, this revenue procedure makes the following changes to Rev. Proc. 2008-24: First, the 12-month period referred to in section 4.01(a) of Rev. Proc. 2008-24 is reduced to 180 days. Second, the rule requiring that one of the enumerated § 72(q) conditions be met (or that a similar life event occur) is eliminated. Third, the limitations on amounts withdrawn from or received under an annuity contract involved in a partial exchange do not apply to amounts received as an annuity for a period of 10 years or more or during one or more lives. Fourth, the automatic characterization of a transfer as either a tax-free exchange under § 1035 or a distribution taxable under § 72(e) followed by a payment for a second contract is eliminated. Under this approach, if a direct transfer of a portion of the cash surrender value of an existing annuity contract for a second annuity contract does not meet the 180-day test described above, the Service will apply general tax principles to determine the substance, and hence the treatment, of the transfer. Thus, for example, an amount described by § 72(e)(1)(A) that is received under either the original contract or the new contract within 180 days of the exchange may be characterized as either boot in a tax free exchange (see § 1035(d)(1) and 1031(c)) or a distribution under § 72(e).

### SECTION 3. SCOPE

01 This revenue procedure applies to the direct transfer of a portion of the cash surrender value of an existing annuity contract for a second annuity contract, regardless of whether the two annuity contracts are issued by the same or different companies.

02 This revenue procedure does not apply to transactions to which § 72(a)(2) applies.

### SECTION 4. PROCEDURE

01 A transfer that is within the scope of this revenue procedure will be treated as a tax-free exchange under § 1035 if no amount, other than an amount received as an annuity for a period of 10 years or more or during one or more lives, is received under either the original contract or the new contract during the 180 days beginning on the date of the transfer (in the case of a new contract, the date the contract is placed in-force). A subsequent direct transfer of all or a portion of either contract involved in an exchange described in this section 4.01 is not taken into account for purposes of applying this section if the subsequent transfer qualifies (or is intended to qualify) as a tax-free exchange under § 1035.

02 A transfer that is within the scope of this revenue procedure but not described in section 4.01 will be characterized in a manner consistent with its substance, based on general tax principles and all the facts and circumstances.

03 The Service will not require aggregation pursuant to the authority of § 72(e)(12), or otherwise, of an original, pre-existing contract with a second contract that is the subject of a tax-free exchange under § 1035 and section 4.01 of this revenue procedure, even if both contracts are issued by the same insurance company, but will instead treat the contracts as separate annuity contracts. See Rev. Rul. 2003-76; Rev. Rul. 2007-38, 2007-1 C.B. 1420.

### SECTION 5. EFFECTIVE DATE

This revenue procedure is effective for transfers described in section 3 of this revenue procedure that are completed on or after October 24, 2011. Rev. Proc. 2008-24 will continue to apply to transfers that are completed before that date, with the clarification of the requirement of section 4.01(b) that one of the prescribed conditions of § 72(q)(2) have “occurred between” the date of the transfer and the date of the withdrawal or surrender will be treated as satisfied if the condition was satisfied as of the date of the withdrawal or surrender. Thus, for example, an individual who attained the age of 59 ½ before both the date of the transfer and the date of the withdrawal or surrender has satisfied the condition of § 72(q)(2)(A) and will be treated as satisfying section 4.01(b) of Rev. Proc. 2008-24.

### SECTION 7. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 2008-24 is modified and superseded. 8

### DRAFTING INFORMATION

The principal author of this revenue procedure is John E. Glover of the Office of the Associate Chief Counsel (Financial Institutions & Products). For further information regarding this revenue procedure, contact Mr. Glover at (202) 622-3970 (not a toll-free call).1035 Exchanges 16, 17, 23, 58, 61, 62, 63

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