

 **INSURANCE TAX SEMINAR**
May 30 - 31, 2019
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What's an Annuity?

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Annuities have existed for a long, long time ...


"Aegon" and Daenerys Targaryen


ANNUITATEM





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Annuities now ... the basics

- Insurance contract:
 - Can be issued only by a state-regulated life insurer
- Purpose:
 - Accumulate retirement savings and / or
 - Pay retirement income
- Key features:
 - Tax-deferred accumulation
 - Periodic income payments, e.g., monthly payments for life
 - Death benefits




RETIREMENT IS COMING



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Insurance protections & guarantees


- Longevity risk – guaranteed income for one or two lives
- Premature death – return of some or all savings
- Market risk – guaranteed returns
- Inflation risk – equity investments, indexed returns, COLAs



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Principle types of annuities (non-tax)

- ***Deferred***: Accumulation or saving period followed by payout period
- ***Immediate***: No accumulation period; payout begins within a year
- ***Deferred income***: Cross between deferred and immediate; no accumulation value but payout is deferred. Also called DIA or longevity insurance; QLACs are an example
- ***Fixed***: Principal and minimum interest crediting rate guaranteed, with higher interest credits depending on interest rate environment
- ***Fixed indexed***: Fixed annuity with interest tied to market index like S&P 500
- ***Variable***: Benefits and values fluctuate with investments, e.g., mutual funds



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Retirement savings & income

- ***Savings: Deferred annuities in accumulation phase***
 - Tax deferral allows the individual to save more *for retirement*
 - Flexible premiums allow the individual to save on his or her own terms
 - Product variety accommodates different risk tolerance levels
- ***Income: Annuitizations, guaranteed withdrawals***
 - Insurance – annuities shift and pool longevity risk
 - Traditional annuity options – lifetime income
 - Guaranteed lifetime withdrawal benefits – lifetime income with flexibility



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Tax distinctions


- “Individual” or “non-qualified” annuities
 - Not related to any tax-qualified retirement plan or IRA
 - The focus of this presentation
- “Qualified” annuities and individual retirement annuities
 - Employer-sponsored plans, IRAs
 - Different tax rules apply, but the basics are the same



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Key tax attributes (non-qualified)


- Taxes deferred on “inside buildup” until distributed
 - Generally only for individuals
- Different ordering rules for recovering basis
 - Annuity payments, withdrawals, surrenders
- Penalty tax
- Post-death required distributions
- Deemed distributions in some cases
- Ordinary income tax rates in all cases



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What's the tax law definition?

- No comprehensive statutory definition, but ...
- Defining characteristics may be discerned from:
 - Treasury regulations
 - Case law
 - Certain statutory provisions
 - IRS guidance
- Again, qualified annuities distinguished



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Code & regulations

- Treasury regulations under IRC § 72
 - “Customary practices of life insurance companies”
 - Product innovation?
- IRC § 72(s): after-death distribution requirements
- IRC § 72(u): non-natural holders
- IRC § 817(h): variable contracts
- IRC § 1035: exchanges



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Amortization of principal & interest

- Periodic payments made at least annually
 - Regulations and case law
- Liquidation of principal and earnings
 - *Igleheart v. Commissioner*
- Presence of annuity purchase rate guarantees
- Agreements to pay interest distinguished
 - Principal left substantially intact
 - Interest payments includible in gross income



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Amortization (continued)

- Annuity starting date issues
 - Maximum annuity starting date
 - Is a maximum annuity starting date required?
 - Qualified v. non-qualified contracts
 - Extending the annuity starting date
 - Failure to annuitize



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IRC § 72(s): post-death distributions


- Contract must “provide” that certain distributions will be made after death of any holder
- Failure to satisfy:
 - Earnings currently taxable; no guidance on how
- Exceptions
 - Structured settlement annuities
 - Qualified annuities, IRAs
 - Contracts issued before Jan. 19, 1985

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Post-death distributions (continued)


- Requirements triggered on death of any “holder”
 - Multiple holders: Death of any triggers requirements
 - “Holder” not defined
 - Generally the named “owner” but facts may matter
 - Special rule for contracts held by non-natural persons
 - Death / change of “primary annuitant” treated as death of holder
 - Owner-driven vs. annuitant-driven contracts

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Post-death distributions (continued)

- Rules differ depending on when the holder dies in relation to the annuity starting date (ASD)
- ASD is the later of:
 - “the date on which the obligations under the contract become fixed,” and
 - “the first day of the period which ends on the date of the first annuity payment.” (Reg. sec. 1.72-4(b))

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Post-death distributions (continued)

- Death before the ASD: In general, the entire interest must be distributed:
 - within 5 years of the holder’s death, OR
 - over the life (or over a period not extending beyond the life expectancy) of the “designated beneficiary,” commencing within 1 year of the holder’s death
 - Spouse beneficiary can continue as the holder without required distributions upon the holder’s death

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Post-death distributions (continued)

- Death on or after the ASD:
 - Any remaining interest in the contract must be distributed at least as rapidly as under the method of distribution being used as of the date of death
 - The beneficiary exceptions technically are available, but contracts typically do not provide for them post-ASD

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IRC § 72(u): non-natural holders

- A contract held by a non-natural person is not treated as an annuity for federal tax purposes
- Income on the contract is currently taxable
 - Only for contributions to contracts after Feb. 28, 1986

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Non-natural holders (cont.)

- Income on the contract for the year:
 - Net surrender value at year-end plus all distributions to date, over
 - Premiums paid (net of dividends) plus all taxable distributions to date
- Effect on issuer
 - Insurance company taxation not affected
 - Reporting, withholding, recordkeeping obligations?



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Non-natural holders (cont.)

- Exceptions
 - Contract held by a trust or other entity as an agent for a natural person or persons
 - Immediate annuity as defined in IRC § 72(u)(4)
 - Contract acquired by decedent's estate by reason of decedent's death
 - Structured settlement annuity
 - Contract held in one of certain enumerated qualified arrangements




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IRC § 817(d): variable contracts


- Variable contract defined in IRC § 817(d):
 - Amounts under the contract are allocated to a state law segregated asset account (SAA)
 - Provides for the “payment of annuities”
 - Amounts paid in or out reflect investment return & market value of the SAA



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IRC § 817(h): diversification rules


- Apply to variable contracts under IRC § 817(d)
- Do not apply to pension plan contracts
 - 401(a) plans, 403(b) contracts, IRAs, etc.
- If fail, contract loses tax status for owner & insurer
 - Ordinary income (not treated as owner of assets in SAA)



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Diversification rules (continued)

- Each “segregated asset account” must comply
 - Typically, each sub-account / investment option
 - Concentration limits: no more than ...
 - 55% in 1 investment
 - 70% in 2 investments
 - 80% in 3 investments
 - 90% in 4 investments
 - Test at end of each calendar quarter w/ 30-day cure window

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Diversification rules (continued)

- Aggregation rules:
 - Securities of same issuer = single investment
 - Interests in same commodity = single investment
- Special rules for government securities
 - Each agency / instrumentality = separate issuer
- Safe harbor if meet RIC rules, tightened somewhat
- Start-up & wind-down periods

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Diversification rules (continued)

- Managed accounts vs. investment entities
- Look-through rule
 - RICs, REITs, partnerships, grantor trusts
 - Insurance-dedicated
 - Other permitted investors
 - Manager, general account, qualified plans, 529 plans, etc.



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Diversification rules (continued)

- Special rule for U.S. Treasury securities
 - Annuities vs. life insurance
 - Direct vs. indirect obligor



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Investor Control


- Policyholder deemed to own the separate account assets for tax purposes if controls them
- Two related indicators of control:
 - Actual control over asset acquisition, disposition, management
 - Use of publicly available pools of assets



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1035 exchanges


- “Annuity contract” is defined as a contract that meets the definition of an endowment contract but “may be payable during the life of the annuitant only in installments”
 - Also, a contract will not fail to be an annuity solely because a qualified long-term care insurance contract is part of or a rider to the contract
- “Endowment contract” is defined 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



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Special situations

- Qualified annuities
 - IRC § 401(g) non-transferability
 - IRC § 817(e) variable contracts / subchapter L
- Structured settlement annuities
 - IRC § 130 and “lumpy” payments



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