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New Guidance on Splitting Annuities to Defer Income

Background

Many farmers have invested in tax-deferred annuities as a conservative investment. Clients are attracted to these investment products because a portfolio of mutual funds can be bundled within an annuity, and all growth and earnings are tax-deferred if no withdrawals occur. But as annuity owners reach retirement age, many prefer taking occasional partial distributions from the annuity versus the permanent annuitizing of the contract.

If the taxpayer annuitizes the contract, each distribution will be partially ordinary income and part non-taxable return of principal. However, if the retiree prefers to take occasional distributions, each distribution is taxed 100% as ordinary income to the extent of accumulated annuity earnings. After all of these earnings are distributed, then any remaining distributions constitute tax-free return of principal [Sec. 72(e)(2)]. Also, extractions of income prior to age 59½ generally result in a 10% early withdrawal penalty [Sec. 72(q)].

Deferring the untapped income in an annuity to the next generation is not necessarily an effective strategy, because there is no step-up in basis. Deferred annuity income is “income in respect of a decedent” and simply pushes the decedent’s ordinary income in the contract to the heirs.

Example

Assume Farmer Brown purchases an annuity contract for $100,000 that has grown to $200,000 of value. If he takes a partial distribution of up to $100,000, then the amount distributed is considered ordinary income. Anything in excess of $100,000 is considered a tax-free return of principal.

To escape immediate taxation on all earnings, some taxpayers were employing a strategy of purchasing multiple annuity contracts from an insurer. Farmer Brown, instead of purchasing one contract for $100,000 would purchase four $25,000 contracts. Each annuity increases in value to $50,000 and if Farmer Brown cashed in one of the annuities for $50,000, only $25,000 was taxed. Sec. 72(e)(12) was then enacted to prevent this strategy by requiring aggregation of all annuities purchased from one insurance company during any calendar year.

Easing of Rules: Rev. Proc. 2008-24

Rev. Proc. 2008-24 allowed a partial transfer of an annuity into one or more annuities to be tax-free under Sec. 1035 provided either of the following:

- No amounts are withdrawn from any of the annuities involved in the exchange for a period of twelve (12) months beginning on the date which amounts are treated as received as premiums (i.e., when the contract was placed in force by the insurance company), or

- The taxpayer can demonstrate that one of the conditions described in Sec. 72(q)(2)(A),(B),(C),(E),(F),(G),(H) or (J), or any similar life event (such as divorce or loss of employment) occur between the date of the transfer and the date of the withdrawal or surrender.

Another key feature of this procedure was the elimination of the aggregation rules of Sec. 72(e)(12). By removing this provision, a taxpayer could now transfer part of the current annuity into a new annuity with the

same insurance company, wait 12 months, then cash in one of the annuities and receive partly non-taxable distributions.

Taking our earlier example, let's assume Farmer Brown splits his annuity in half. The old and new annuities are now each worth $100,000 with a basis of $50,000. In this example, if Farmer Brown cashes in one of the annuities after waiting 12 months for $100,000, and assuming he has attained age 59½ so that no penalty applies, only $50,000 is taxable, even though the annuity is with the same insurance company.

Further Easing of Rules: Rev. Proc. 2011-38

Since 2008, the IRS learned of several practical issues that had diminished the effectiveness of Rev. Proc. 2008-24. Some of these issues were:

- Many taxpayers had 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 Sec. 72(q)(2) or to similar life events.

- Others commented 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.

In response, the IRS issued Rev Proc 2011-38. This procedure:

1. Reduces the 12-month waiting period to 180 days.

2. Eliminates the rule requiring one of the enumerated Sec. 72(q)(2) conditions (or similar life events) be met.

3. Removes the waiting period for an annuitization. If the payments are to be received as an annuity for a period of 10 years or more, or are to be annuitized over one or more lives, the 180 day limitation doesn't apply. In essence, the taxpayer can split the annuities, and begin annuitizing a portion immediately without the 180 day restriction.

The Service will continue to not require aggregation pursuant to Sec. 72(e)(12) on these transfers if the second contract is issued by the same insurance company. These provisions are effective for transfers completed on or after October 24, 2011.

Lifetime Annuitization Alternative

Annuities are complex instruments. Not only are the tax rules confusing to most clients, but each annuity can have its own specific contractual terms. But they do all have one important feature that is inherent to the product: The ability to shift the risk of longevity to the insurance company. Generally, a deferred annuity can be "annuitized" with the insurance company at any point. In exchange for the asset value within the contract, the insurance company agrees to pay a fixed periodic payment (generally monthly) over the lifetime of the annuitant, or the lifetime of the annuitant and spouse. If the client survives to age 100, the insurance company must continue to pay and the investor has essentially won the mortality bet.

This feature could be important to that retiree without a significant land base to provide a strong retirement income. Unfortunately, in this era of very low interest rates, it is not the optimum time to lock in a lifetime annuity payout. But most clients won't understand or even be aware of that choice without some explanation from a financial advisor. Awareness of this feature could be important to a client looking to lock in an income stream that helps mitigate the risk of outliving retirement resources.

Conclusion

If you have clients, such as retired farmers that have built up substantial values in their tax-deferred annuities, splitting these annuities into one or more contracts under the provisions of Rev. Proc. 2011-38 may make sense. By splitting these annuities, the taxpayer may be able to reduce the immediate tax burden of taking a partial distribution from one large annuity. This especially makes sense if the retiree knows that distributions

will be taken over an extended period of time, but does not need consistent monthly income from the annuity.

A factor to consider is that additional surrender charges may apply to distributions on any new annuity contracts. Taxpayers may need to wait five to ten years to escape these surrender charges. However, they would still be able to cash in the original contract if held for longer than the surrender period.

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