

Steve Sternberger's



Business and Estate
Strategies and Tips

"The monthly newsletter for the professional insurance representative"

Non-Qualified Annuity Ownership, Annuitant, and Beneficiary Arrangements... Does it Really Matter?

Selling non-qualified annuities is usually portrayed as a rather simple matter. Match a product to a client's needs for accumulation and distribution, collect the premium, and earn a commission. Does sound simple, doesn't it? But as we all know, "the devil is in the details", and since annuities are tax-favored products, what sounds simple can easily become very complicated, especially when an owner or annuitant dies. And, since annuities have evolved over time to take advantage of whatever the Internal Revenue Code allows, picking the right annuity and arranging the parties in a fashion that makes the most sense for today and tomorrow really can be quite challenging. Don't think so? Read on...

Deferred annuities today generally fall into two categories: (1) Annuitant-driven, and (2) Owner-driven. Annuitant-driven annuities are those that contractually pay a death benefit when the annuitant dies. When the annuitant dies, the contract terminates and the death benefit, if any, is paid to the contract's designated beneficiary. (It should be noted that these contracts also pay a benefit when the owner dies because federal law mandates that a complete distribution occur within 5 years of the death of any owner of an annuity contract. These are the so-called "death of the owner rules" contained within the Internal Revenue Code.) Owner-driven annuities, on the other hand, are those that pay a death benefit only when the owner of the contract dies. When the annuitant dies, the owner simply designates a new annuitant (presuming that the owner of the contract is NOT a non-natural person...more on that later!). The contract goes on without skipping a beat. Note that regardless of the annuity's design, it is the *owner* who controls the policy. If the annuitant and owner are different, the annuitant has no ownership rights in the contract!

So what's the big deal, you ask? Plenty. Initially, agents must determine, based on the client's objectives, which annuity design best suits the fact pattern. Now if the owner and the annuitant are to be the same person, it might not be a big deal. But more and more, we're finding that clients purchasing annuities want to name an annuitant other than themselves, for whatever reason makes sense to them. Thus, it becomes the agent's responsibility to explain the difference between the two general types of contracts and then help the client choose which type best suits the client's objectives. Does the client want a death benefit to be paid when the annuitant dies? Or only when the owner dies?

Naming an annuitant different from the owner has other implications, too. We all know there needs to be a beneficiary named to receive any death benefits that might be payable when the triggering life ends. After all, we don't want the proceeds flowing to the deceased's estate, or worse, end up being interpleaded if the insurer can't determine who is rightly entitled to the proceeds. Our job is to limit costs, not add to them!

But a beneficiary designation is important from a tax perspective as well. As a general rule, with an annuitant-driven annuity, it is rarely advisable to have 3 parties to the annuity...an owner, a different annuitant, and still a different person designated as beneficiary. Why? Because of the potential for making an inadvertent gift at the death of the annuitant. The death of the annuitant triggers a payment to the beneficiary under a contract owned by someone other than the annuitant. The result is likely an "imputed gift" from the owner of the contract to the beneficiary of the proceeds receivable by the beneficiary. This could result in the owner paying gift tax on the gift (presuming it is large enough to trigger a gift tax) AND the beneficiary paying income tax on the interest portion of the proceeds the beneficiary receives. It is the worst of all worlds when it comes to proper annuity planning.

Using an owner-driven annuity likely mitigates this result because the annuitant isn't truly an active party to the contract. The annuitant is simply the measuring life on which annuity payments will be based. But beyond that, the annuitant has no other role...unless the contract is owned by a non-natural person as an agent for a natural person. Since the death of the annuitant is treated as the death of the owner for tax purposes in this instance, there is an opening for the IRS to assert that in fact there is a transfer of money at payout from the non-natural owner to the designated beneficiary predicated on a third party's life. That could lead to disastrous results, namely either a taxable gift of the proceeds or fully taxable income being paid to the beneficiary depending on the beneficiary's relationship to the owner. For example, if the beneficiary were an employee, the payment could be construed as compensation. If the beneficiary were a stockholder in the non-natural owner, the payment could be construed as a disguised dividend.

As you can see, naming three different parties to the contract can create tax issues where no one thought they might exist. It's a potentially disruptive and expensive problem, and it's also generally impossible to fix once death occurs. Better to plan up-front to avoid this situation altogether. And the solution is really quite simple: Whenever you have an annuitant and owner who are different people, be certain one or the other is also designated the beneficiary of the contract.

For example, if A owns a contract on B's life and the contract is owner-driven, when A dies, the contract will pay out. To whom? Ideally, it should pay out to B as the designated beneficiary. And, if B is also the surviving spouse, B then has the choice of continuing the contract in B's own name and continuing the tax deferral that has built up while both A and B were living. What if the contract were annuitant-driven? Then A should be both owner and beneficiary. At B's death, the contract will pay out to A. While A will NOT be able to continue the contract (the provision of the Internal Revenue Code governing continuation has effect ONLY when an owner dies), A will at least have the money A likely paid for the contract, as well as any interest the contract earned. A is then free to do what he/she wishes with the proceeds, including purchase a new annuity,

perhaps for the benefit of someone else, such as a child, or take an income from the contract and spread any taxable gain out over time.

One last topic: Joint ownership. While permitted, joint ownership should only be undertaken when absolutely necessary. Remember, the death of the owner rules require that a distribution of the contract occur upon the death of ANY joint owner. This means at the death of the first joint owner to die, the contract, if not in payout status, must fully pay out within 5 years. Designating a spouse as joint owner does NOT assure that continuation will be permitted, unless care is taken to assure that both joint owners are also designated as joint beneficiaries. It also is problematic if you have joint owners but designate only one as a beneficiary. If that person happens to die and no contingent or joint beneficiary is named, you could well have a situation in which proceeds will have to be paid to the deceased owner's estate, or worse, interpleaded if the surviving joint owner asserts entitlement to the death benefit. Joint ownership should only be undertaken upon assurance the parties fully understand the potential ramifications of such an ownership designation and the implications of joint ownership in either a common-law or community property context. Whenever possible, this author believes it is best to avoid joint ownership designations altogether.

The arrangement of owner, annuitant, and beneficiary on any annuity contract really DOES matter. If you want your client's wishes to be realized in the most tax-efficient manner possible, it is critical that you, the insurance professional, bring your knowledge and expertise to bear when it comes to assuring a contract is set up and functions logistically in a manner that meets the client's objectives and is most suitable to the client's specific situation. The Internal Revenue Code giveth, and it taketh away from the unwary. Don't be among those who contribute unnecessarily to the problem. Instead, be the source of solutions and reap the benefits in terms of commissions and referrals that will keep you in good stead and in business for as long as you want to be.

Good Selling!

A handwritten signature in black ink, appearing to read "S. Sternberger", with a stylized, flowing script.

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