



Advanced Planning Strategies

**Albert E. Gibbons, CLU, ChFC, AEP
President, AEG Financial Services**

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Dear Reader,

The Senate Finance Committee approved the language of The “National Employee Savings and Trust Equity Guarantee Act” (S. 1971). This bill is designed to protect the retirement security of American workers by requiring adequate diversification and giving participants access to information about their pension plans. The bill is a reaction by Congress to recent corporate bankruptcies where retirement plans were largely invested in employer securities. Among other provisions, the bill would permit participants to direct alternative investment of their plan accounts. To prevent hardship for employers, the plan permitting such diversification would be phased in over 3 years beginning in 2003.

The annual cry for tax simplification has taken the form of a new proposal, the “Tax Simplification Act of 2002” (H.R. 5166). This bill would repeal the individual and corporate alternative minimum tax (AMT). Long-term capital gains would become eligible for a 50 percent exclusion from taxes, rather than the current multiple tax rates. Many of the phaseouts of tax benefits would be eliminated. We focused on tax phaseouts in a previous edition of this letter. Along with the complexity these phaseouts add to return filing, their net result for affected taxpayers is an extremely high marginal tax bracket. The legislation also contains an increase in the exclusion from income taxes for employer-provided group-term life insurance from \$50,000 to \$100,000 of coverage. Finally, the safe harbor for estimated taxes would be set at 90 percent of the actual tax liability for the current year or 100 percent of the tax liability for the prior year. Higher-income individuals who file estimated taxes would benefit from this relief.

The popular press has recently created a controversy with the discussion of a life insurance estate planning technique. The New York Times reported that wealthy taxpayers were investing in large life insurance policies to solve estate tax problems but paying gift taxes on only a fraction of premiums. This technique is known as private split-dollar life insurance and has been discussed in previous editions of this letter. Private split-dollar designs have been approved by the IRS in private letter rulings and are based on established tax principles. The IRS did not take the publicity of a major news story lightly, however, and issued Notice 2002-59 (2002-36 I.R.B.). This Notice indicates that the tables used to value split-dollar life insurance cannot be used in fact patterns where one party creates the split-dollar arrangement and retains the right to the current life insurance protection. This Notice appears hastily drafted and is somewhat ambiguous. We would expect further clarification.

Knowledge is not power. Only knowledge in use is power.

TAX PLANNING WITH DEFERRED ANNUITIES

WHAT IS AN ANNUITY?

An annuity is defined as a systematic liquidation of a principal amount, with interest, over a fixed term or a period of time based on one or more life expectancies. A commercial annuity involves a contract with an insurance company, under which the contract owner pays the insurance company a premium in one or more installments. In return, the company promises to make some form of annuity payment, either immediately or at a determined or undetermined time in the future. Often, the actual annuity payment under the contract is deferred for some period of time at the election of the contract owner. During this period of deferral, the contract will accumulate in one of two ways, depending on the type of annuity. The accumulation could be based on interest rates (a fixed annuity) specified by the insurance company in the form of both current and guaranteed rates. Or, in the case of a variable annuity, the accumulation would be based on investment options selected by the contract owner. The contract owner absorbs the risk associated with the investment decisions in this instance.

HOW IS THE ANNUITY TAXED?

If the annuity is deferred, the contract owner is not taxed on the accumulation of the funds unless some financial transaction (e.g., a withdrawal or policy loan) is performed with the contract. If such a transaction occurs, the proceeds are taxed on an income first or FIFO basis, unless the contract contains an investment made before August 14, 1982.

If and when the contract is annuitized (i.e., contract funds are paid out in the form of an annuity), the beneficiary receiving the annuity payments (the annuitant) is taxed according to an exclusion ratio in which part of each payment is treated as a nontaxable return of the investment in the contract and part as taxable income on the contract funds until the annuitant's life expectancy is reached. If the annuitant lives beyond his or her life expectancy (based on actuarial tables), the remaining payments are subject to ordinary income taxes. The discussion above is based on a simple life annuity and ignores survivorship or refund (period certain) features that might be selected.

Currently, deferred annuities are popular as accumulation vehicles because of the tax-deferred accumulation feature. These contracts are sometimes never annuitized during the contract owner's lifetime. This raises some questions about the estate planning implications that are discussed below.

THE NON-NATURAL PERSON RULE

A deferred annuity contract owned by certain entities will not be eligible for the tax-deferral feature during the accumulation period. In fact, the contract will not be treated as an annuity at all under the Internal Revenue Code. This means that income accumulating within such a contract will be taxed each year as ordinary income to the contract owner. Obviously, this is an undesirable result. How can ownership of an annuity be arranged to avoid this unfavorable rule? In other words, what types of trusts and business entities are permitted to own deferred annuities? Generally, the non-natural person rule applies to contracts that are not owned by human beings. However, there are important exceptions to this rule, including contracts owned by the estate of a deceased contract owner and contracts owned by entities as an agent for a natural person. The agent-for-a-natural-person exception to the non-natural-person rule has been the subject of much discussion and numerous IRS rulings.

First, the IRS has ruled repeatedly that certain trusts that are taxable as grantor trusts (trusts taxable to the grantor of the trust for income tax purposes) are entities that qualify as an agent for a natural person (e.g., Ltrs. 9120024, PLR 9316018). However, the private rulings in this area have not covered every type of grantor trust. Therefore, some types of grantor trusts may or may not qualify

under the agent-for-a-natural-person exception and therefore be permitted to own an annuity contract without loss of tax benefits. This issue may be important when an annuity is being considered for funding a living irrevocable trust designed to remove assets from the grantor's estate for federal estate tax purposes, yet be taxed as a grantor trust for federal income tax purposes.

Trusts that have only one beneficiary have also been treated under the agent-for-a-natural-person exception (e.g., Ltrs. 9204010, PLR 9204014, PLR 9639057). Such trusts have been treated as agents for a natural person regardless of whether they are grantor trusts. Therefore, trusts with only one beneficiary might be able to own deferred annuities without adverse income tax consequences.

It is significant to note that other income tax problems can arise when an annuity is placed in a trust other than a grantor trust, such as a credit shelter or QTIP marital trust set up for estate planning purposes. For example, in such cases, any taxable income generated by the annuity could be trapped in the trust and taxed at the highly compressed income tax rates applicable to trusts (i.e., taxable at the highest 38.6 percent bracket for income above \$9,200 in 2002). If the terms of the trust prohibit or substantially restrict principal distributions to the trust beneficiary, this problem could be worse. The application of the non-natural-person rule to annuities held by such trusts is uncertain and would depend on the terms of the particular trust and whether the annuity was tailored to fit the particular trust. In one private ruling, a testamentary trust with a life beneficiary and other beneficiaries who would receive property after the life beneficiary's death was considered to be an agent for a natural person (see Ltr. 9752035). Even so, it might not be advisable to have an annuity contract pass into an estate planning trust at the owner's death. Rather, naming an individual as a death beneficiary under the contract is less problematical and will generally result in the maximization of tax deferral on the contract funds.

At this time, it is uncertain whether the IRS would consider a partnership to be an agent for a natural person and permit tax deferral for annuities owned by partnerships. This question has frequently been posed, but the IRS has not ruled on it. Ownership by corporations, on the other hand, is specifically the type of ownership that the non-natural person rule was designed to cover. Such ownership must therefore be avoided (unless the annuity is an immediate annuity in which annuitization occurs within one year of the purchase of the contract).

TAXATION ON THE CONTRACT OWNER'S DEATH

If an annuity contract is still in the deferral period and the owner wishes to continue tax-deferred accumulation as long as possible (even after his or her death), what are the options? The best option is to name the spouse as the death beneficiary under the contract. If the spouse receives the contract upon the owner's death, the spouse may continue to accumulate the funds on a tax-deferred basis just as if he or she had originally owned the contract. If an individual other than a spouse is named as the death beneficiary, deferred accumulation of all the funds in the contract cannot continue. The funds must either be paid out over a 5-year period or distributed over the designated beneficiary's lifetime, with payments commencing within one year of the owner's death. In such cases, annuities may be more valuable as asset-accumulation and retirement vehicles than as asset-transfer vehicles, particularly because these contracts do not generally receive a basis step-up at the owner's death. However, it is necessary to examine carefully the benefits of long-term income tax deferral before determining the deferred annuity's efficiency as an asset-transfer vehicle.

For estate tax purposes, the annuity is in the contract owner's gross estate if annuity benefits are payable to a survivor to the extent (proportionately) that the contract owner paid for the contract. The estate taxes payable as result of the annuity are available as a deduction against the income taxes due when the annuity payments are taxable to the beneficiary.

This has been only a quick overview of the many income and estate tax issues concerning annuity policies. Careful planning should accompany any extraordinary ownership or beneficiary choices.

RECENT CASES AND RULINGS**TRANSFER OF INSURANCE POLICIES AVOIDS ADVERSE INCOME TAX CONSEQUENCES**

Husband (H) created two trusts (T1 and T2). T2 was designed to hold life insurance policies covering the lives of H and his wife (W). The language in T2 indicated that the income and principal of T2 could be used to pay premiums on life insurance covering the lives of any individuals in which the trust's beneficiaries had an insurable interest. This provision makes H the income tax owner of T2 under the grantor trust provisions of IRC Sec. 677. T2 applied for and became the owner of second-to-die (survivorship) life insurance policies covering the lives of H and W. Apparently, H decided that he wished to change the provisions of his life insurance trust. He created a third trust (T3), which also qualified as a grantor trust, adding additional beneficiaries and provisions restricting distributions to the original beneficiaries if such beneficiaries married without entering into prenuptial agreements.

H made gifts to T3, and its trustee purchased the life insurance policies from T2, paying full value as provided by the gift tax regulations. An investment partnership was also established with T1, H, W, and T3 as limited partners. A private ruling was requested to establish whether or not the life insurance policies would become taxable at the death of the survivor of H and W when the proceeds were received by T3.

The transfer-for-value rule provides that benefits from a life insurance policy become taxable if the policy was transferred for valuable consideration unless an exception applies. The IRS held (Ltr. 200228019) that this transaction would preserve the normal income-tax-free receipt of death benefits from a life insurance policy when T3 receives the policy proceeds. Since T2 and T3 are grantor trusts, the transfer of the policy is disregarded for income tax purposes because H remains the income tax owner of both trusts. Thus, the transaction could not be treated as a transfer for value under IRC Sec. 101(a)(2). In addition, the transfer of life insurance policies for valuable consideration to a partnership in which the insured is a partner or to a partner of the insured is excepted from the transfer-for-value rule. Hence, the transaction would also be protected by the formation of the partnership in which T3 is a partner of the insured. The IRS has indicated in its business plan, however, that it will not issue advance rulings on this issue.

This letter prepared, with the help of a nationally recognized tax authority, intends to promote interest in more comprehensive tax and estate planning. References are intentionally brief. If a topic interests you, you should investigate it more thoroughly with your qualified tax advisor. Effective tax and estate planning should involve competent advisors in relevant law, accounting, trusts, life insurance and investments. The knowledge and experience of each in their specialties can make the difference between a wealth transfer that works as intended and one that does not. Please seek competent counsel to determine and satisfy your individual needs.

*Positioning our clients
for the future*



Albert E. Gibbons, CLU, ChFC, AEP
AEG FINANCIAL SERVICES
 1288 Valley Forge Road, #53
 Phoenixville, PA 19460
 Tel. (610) 917-8940
 Fax. (610) 917-8962
 Email. algibbons@algibbons.com
 Web: www.algibbons.com