

THE RISELING REPORT

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ANNUITIES—ARE THEY SUITABLE FOR SENIORS?

Introduction

During the summer of 2002, articles concerning the suitability of annuities appeared in several financial publications. Annuities are a little tricky to understand, thus it might be helpful to review the basic consequences of investing in annuities so that we can better assist our clients in evaluating their suitability for the client.

The Three Fundamental Aspects of An Annuity

The Return of the Benefits

As to the distributions from an annuity to its beneficiary, there are two (2) types of annuities; **DEFERRED** or **IMMEDIATE**. Most investors will be advised to consider a tax deferred annuity (“TDA”). A TDA is an annuity in which savings are accumulated income tax free over a period before payments to the payee commence. An immediate annuity is an annuity where payments are made to the payee within the first year following the initial premium payment (i.e. investment). A TDA can be converted into an immediate annuity.

The Underlying Investment

As to the investment within an annuity, there are two (2) types; **FIXED** or **VARIABLE**. A fixed annuity provides fixed guarantee dollar benefit. A fixed annuity is similar to a Certificate of Deposit, but may not be protected like a Certificate of Deposit via the FDIC. A variable annuity is one in which the investment rate of return varies with investment performance. A variable annuity, by its very nature is not guaranteed. A variable annuity indirectly (via a mutual fund) invests in stocks, bonds and securities which are generally not protected.

The Source of the Investment

As to the income tax aspects of an annuity, there are two (2) types, **QUALIFIED** or **NONQUALIFIED**. A qualified annuity (deferred or immediate), (variable or fixed) is an annuity that receives special tax treatment because it is purchased in connection with a retirement plan or individual retirement account (“IRA”). A nonqualified annuity (deferred or immediate), (variable or fixed) is not purchased in connection with a retirement plan or IRA.

Considerations

To look at the suitability of an annuity, the following points should be examined:

1. **SURRENDER CHARGES.** Typical surrender charges will decline over a period of years, usually anywhere from 3 to 10 years. It may not make much sense for an 85 year old person to purchase an annuity with a 10 year surrender charge.
2. **SALES CHARGES.** Every annuity has a sales charge. Every investment, except a time deposit or certificate of deposit, likewise usually has a sales charge. For example, when one purchases a stock, bond, or mutual fund; part of the purchase price or cost is a sales charge or broker commission.
3. **TAX DEFERRAL.** Many people list tax deferral as a principal reason for buying a TDA.

In order to qualify the investment as an Annuity and enjoy the benefits of income tax deferral, there are two (2) Internal Revenue Code of 1986 (the "Code") requirements which must be satisfied. These requirements are found in §72 of the Code. Here is a rundown of the basic requirements:

1. There must be a death benefit;
2. A natural person must hold the annuity. There is an exception in the case of a Grantor Trust (such as a revocable trust) if the annuity contract is held by the Trust as an agent for a natural person. This exception is found in Letter Ruling 9322011. Note however, that this exception is somewhat limited and will not apply if the trust in question is not a Grantor Trust. We have encountered this problem several times where investment advisors have sold a TDA to a corporation or an irrevocable (non-Grantor) trust.

The advantage of income tax deferral must be considered against the disadvantage of the potential of having the accumulated deferred income received in lump sum and consequently taxed all at one time as ordinary income.

4. **CHARACTER OF INCOME.** To the extent the annuity has increased in value (either earnings [dividends or interest] or gains [from the sale of the mutual fund within the annuity]), the receipt of distributions by the owner or beneficiary of the annuity will be taxed as ordinary income. Had the investment not been housed within an annuity, the growth due to capital gains would have been taxed at capital gains rate. In other words, annuity distributions do not enjoy the favorable capital gain treatment afforded other non-annuity investments.

5. **NO STEP UP IN BASIS.** A beneficiary who inherits stock or a mutual fund receives a step up in basis at death. When this occurs any unrealized gain escape income tax. However, there is no step up in basis at death for an annuity.

6. **EARLY WITHDRAWAL PENALTY.** There is a 10% penalty on distributions from an annuity prior to the owner attaining age 59½ years. Certain other exceptions to the imposition of the penalty are also available, such as disability, death, payments in a series of substantially equal periodic payments, etc.

7. **CREDITOR PROTECTION.** Oklahoma State Law specifically prohibits creditors from executing, garnishing or levying an annuity. Oklahoma Statute (“O.S.”) **36 O.S. §3631.1 AND 31 O.S. §1.A.20.** There are a few exceptions. In many cases, the investment in an annuity may provide the owner and beneficiary creditor protection.

8. **MEDICAID (WELFARE) PLANNING.** Finally, some states allow a transfer (exchange) of assets for an annuity in order to qualify the annuity owner for Medicaid. Unfortunately, this is not applicable in all states. This opportunity may disappear in the near future in those states which still permit it.

Closing

Again, the real issue is whether an annuity is suitable for the particular investor, not whether an annuity itself is inherently good or bad. Because of the income tax deferral and creditor protections advantages, the analysis of the suitability for a particular client may be complicated.

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