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# Ten Big Annuity Mistakes

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Mistakes with annuities can be costly, but they can also be avoided. Understanding the following ten commonly seen mistakes can help you bring value to your clients and to you.

## **Mistake # 10**

### **Naming the client's estate as beneficiary, or having no beneficiary at all.**

When there is not an individual beneficiary named, or the named beneficiary has pre-deceased the annuity owner, the proceeds of the annuity will flow into the owner's estate. When the estate receives the proceeds, they will be subject to the probate process and be distributed according to the provisions of the client's will, or under state law.

The probate process is simply the process by which a court gathers all of an individual's assets and distributes them appropriately. One important reason people invest in annuities is to avoid the probate process. In fact, any product that allows for a beneficiary designation is intended to bypass probate. However, if there is no beneficiary to give the proceeds to, the estate of the annuity owner will receive them. This is probably the opposite of what the client intended.

## **Mistake # 9**

### **No contingent beneficiary.**

Going hand in hand with Mistake # 10, a contingent beneficiary could make all the difference. If the primary beneficiary is no longer around, the contract will pay to a named contingent beneficiary. If no contingent beneficiary is named, the annuity will pay to the owner's estate and will again be subject to the probate process. Generally, a contingent beneficiary will receive annuity proceeds only if there are no surviving primary beneficiaries.

Consider naming a trust or a charity as contingent beneficiary for situations in which the client does not want the proceeds going to the estate after the deaths of all the primary beneficiaries. Finally, don't forget to name a successor beneficiary to receive extended payments if a client is taking distributions over their lifetime, and die before life expectancy is up.

## **Mistake # 8**

### **Naming a non-natural entity as owner of the annuity contract.**

If a non-natural entity is named as the owner of an annuity, the annuity will not receive tax deferral of any gains in the contract. Non-natural entities are usually business entities such as corporations, partnerships, LLC's, LLP's, etc. The exception to this rule would be not-for-profit entities, as they do not pay income taxes. For this reason, many companies will choose to invest in something other than an annuity.

Typically, if a trust is named as owner, the trust will receive tax deferral if the trust is acting as an agent for a natural person. Many trusts will meet this requirement, as they have living human beings as trust beneficiaries. However, since there is no provision in the IRS code to allow for it, there can

be no life expectancy payout. All distributions from the annuity must be paid out within five years from the death of the owner or annuitant, depending on the contract structure.

#### **Mistake # 7**

##### **Imposition of tax upon change of ownership or assignment.**

Whenever ownership is changed or when an annuity is assigned as collateral, all gains in the contract will be subject to income taxation at the time of the change. This can be a fine point that can be easily missed, but some insurance companies may not generate a 1099 tax form because no money has been moved from the contract. Even if this is the case, the taxpayer is still responsible for paying the income tax due, and may pay penalties and interest for non-compliance. It is important to remember that some companies have a corporate policy to not allow for the assignment of an annuity.

Also sometimes lost in such a transaction is the imposition of gift tax. If the change of ownership results in a taxable gift of an amount over the annual exclusion (currently \$14,000 per person per year), there must be a gift tax form filed at the time of the change. Finally, gifts between spouses are exempt from this rule.

#### **Mistake # 6**

##### **Taking distributions too soon after making partial exchanges.**

Partial exchanges are a relatively new development in annuity planning. In a partial exchange, the basis and any gains are prorated between the two contracts. For example, if the annuity is split into two equal amounts, the basis will be split equally, too. This can be advantageous for clients who want to get to the basis in the contract sooner who would be otherwise achievable. However, if any distributions are made within 180 days of the partial exchange, the contracts will be aggregated for taxation purposes.

#### **Mistake # 5**

##### **Should an annuity be surrendered or exchanged?**

On a 1035 exchange, basis is carried from the old contract to the new contract, therefore, the relationship of cash value to basis must be examined. If the surrender value is more than the cost basis, there would be an income taxable gain on the proceeds. If there is an exchange, that taxation will be delayed until money is distributed from the contract.

In a more likely scenario, if the surrender value is less than basis, the client has a decision to make. If the annuity is surrendered, it may be possible to take an itemized income tax deduction for the loss. On the flip side, if the annuity is exchanged, this basis will be preserved and any growth in the annuity up to the original basis will be tax free. Obviously, it will be a facts and circumstances decision in each case.

#### **Mistake # 4**

##### **Buying two annuities from the same company in the same year.**

In this scenario, the annuities will be aggregated and treated as one annuity for income tax purposes. This means that access to non-taxable basis will be delayed until the gains of both contracts have been distributed and taxed. For an easy remedy, either don't buy in the same year, or don't buy from the same company.

#### **Mistake # 3**

##### **Failing to consider surrender charges.**

If a client decides that their old annuity just doesn't fit the bill anymore, they may want to exchange it for one with more benefits and features. When doing this, remember that the new contract will likely come with lengthy surrender charges. If the client takes distributions before the surrender period has

expired, surrender charges will reduce the amount of money available to the client. Also, don't forget that surrender charges are not tax deductible.

### **Mistake # 2**

#### **Is the contract owner or annuitant driven?**

Annuities come with features and guarantees that are triggered by the death of someone. If it is an owner driven contract, the death of the owner will trigger these features. Conversely, the death of the annuitant will trigger these features in an annuitant driven contract. Keep in mind that death of the annuitant in an owner driven contract will not usually trigger these benefits. However, the death of an owner in an annuitant driven contract may result in a cash value payout subject to surrender charges, but the death of the annuitant could trigger an enhanced death benefit payout not subject to surrender charges. This brings us to perhaps the most important mistake of all.

### **Mistake # 1**

#### **Assuming all annuities are identical.**

Annuity contracts issued by the same company can vary greatly. Annuities issued by different companies can be an entirely different species. Always read the contract or prospectus for any annuity you are selling (or buying). If you don't understand how the contract works, don't sell it (or buy it).

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