Lesson 5 – Uses of Annuities

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Although the non-qualified annuity can be used for many purposes, probably its best and most frequent use is retirement planning. Retirement has been the focus of much attention in recent years. Since people are generally living longer than at any time in history, there are more retirement years to be planned for and, particularly, to be paid for. Another reason for the focus on retirement planning is, of course, the baby boomer generation. Born between 1945 and 1964, those on the older edge of the boomers are now in their 60's and planning seriously for their retirement years. The recent down-sizing of major American corporations also has called attention to the fact that employers cannot be counted on to finance the full cost of an employee's retirement years.

The result of these factors, and others, has been an increased interest in and focus on the financial aspects of retirement. Most Americans expect to receive Social Security benefits at retirement and many are fortunate enough to be participants in qualified retirement plans provided by their employers, although many who are self-employed do not have retirement plans. However, experts warn that if the baby boomer generation is to afford the retirement lifestyle it seems to want, these two sources of retirement income will not be sufficient. Personal savings must make up the difference.

One of the best vehicles to accumulate funds to supplement retirement income from Social Security and qualified retirement plans is a non-qualified annuity. The use of the labels "qualified" and "non-qualified" have nothing to do with the qualification of the annuity or the insurance company issuing it. Instead, these terms refer to whether the annuity is being used as part of a retirement plan that is "qualified" under certain sections of the Internal Revenue Code. A "qualified" annuity is one which is used as part of or in connection with a qualified retirement plan. A "non-qualified" annuity is one which is not used as part of any qualified retirement plan. If the annuity is labeled as non-qualified, this simply means that it may be purchased by any individual or entity and is not associated with an employer-provided plan.

As with many financial planning strategies, earlier is better than later when deciding when to start saving for retirement. If an annuity holder, Mrs. Green, begins saving for retirement at age 40, she will have accumulated a sum of $138,598 at age 65 by saving $200 each month. The same monthly amount started at age 50 would result in a retirement sum of $58,164.

Waiting until age 60, with retirement only five years away, severely cuts down on the available funds, resulting in a sum of only $13,954. If Mrs. Green elected a life income settlement option under the annuity started at age 40, her monthly benefit payment would be $812. Under the annuity started at age 50, the benefit would be $341 while under an annuity started at age 60, she would receive only $82 each month.

The usefulness of starting early can be illustrated another way. Assume that Mrs. Green, with the help of her financial planner, determines that she needs $500 per month at retirement to supplement her retirement income from other sources. If Mrs. Green begins paying premiums into the annuity at age 40, she will need to pay a monthly premium of $123 in order to accumulate the sum of $85,320 which will pay her a life income annuity of about $500 each month when she reaches age 65. If Mrs. Green delays starting the premium payments until she reaches age 50, she will need to pay a premium of $293 each month in order to accumulate funds sufficient to provide the $500 monthly benefit. Waiting until age 60 to begin saving money in the annuity will result in a required monthly premium of $1,223. Clearly, starting early is the best course of action for this type of retirement planning.

Other Retirement Planning Vehicles

To make the best use of the non-qualified annuity in retirement planning, it is essential to have a basic understanding of the other retirement planning techniques available and how these other options fit together with non-qualified annuities. A short discussion of the more commonly-encountered types of retirement plans follows.

Individual Retirement Arrangements

An Individual Retirement Arrangement (IRA) offers several advantages. First, with a traditional IRA, depending upon income levels and participation in other employer-provided retirement plans, an IRA contribution may result in an income tax deduction in the year the contribution is made. Second, interest earned on the funds placed in a traditional IRA is taxed on a deferred basis. That is, interest earned on IRA funds is not taxed until funds are withdrawn from the IRA. Since 1998, another form of IRA, the Roth IRA, has been available.

While contributions made to a Roth IRA are not deductible, funds distributed from a Roth IRA may be received completely free of any income tax, provided certain conditions are satisfied.

An IRA can be either an annuity (an Individual Retirement Annuity) or an account (an Individual Retirement Account). The term “Individual Retirement Arrangement” is often used to refer to both types of IRAs. Typically, annuities are offered by insurance companies and accounts are offered by banks and other financial institutions, but this is not always the case.

With the traditional IRA, an individual can, under current law, contribute up to $5,500 ($6,500, if age 50 or older) to an IRA in his own name assuming that the individual has at least this much earned income for the year. Further, the individual may contribute up to $5,500 to a traditional IRA for a nonworking spouse ($6,500 if age 50 or older), assuming that certain conditions are met. Generally, the amounts of any contributions made to Roth IRAs must be subtracted from this amount.

This contribution to a traditional IRA may or may not be deductible for income tax purposes, depending upon the individual’s income level and participation in other retirement plans. If the individual is an active participant in certain types of employer-provided retirement plans, the amount of his traditional

IRA contribution that is deductible may be limited. For individuals who do not participate in other employer-provided plans, the full contribution may be deducted.

Contributions to a Roth IRA, as mentioned above, are not deductible. An individual may contribute the lesser of $5,500 or 100% of his compensation to a Roth IRA. However, this amount must be reduced by the amount of any contributions made to a traditional IRA in the same year. Further, an individual may contribute up to $5,500 to a Roth IRA for a nonworking spouse. This amount must also be reduced by the amount of any contributions made to a traditional IRA on behalf of the nonworking spouse in the same year. Lastly, it should be noted that the amount that can be contributed to a Roth IRA is lessened and even eliminated for high income taxpayers.

However, for those taxpayers who are eligible to make contributions to Roth IRAs, there are significant tax advantages. Generally, if a distribution from a Roth IRA meets certain requirements and is, therefore, considered to be a "qualified distribution" no portion of the distribution will be includable in the taxpayer's income.

Generally, the requirements are that the distribution is not made for at least five years after the Roth IRA is started and it is made either after the individual reaches age 59 1/2, upon the individual's death or disability or the distribution is a qualified first-time homebuyer distribution.

Like a non-qualified annuity, the interest earned on a traditional IRA is tax deferred. Thus, a traditional IRA holder does not pay income tax on the earnings in his IRA until he begins to withdraw benefits. In contrast, the interest earned on a Roth IRA may never be taxed if received as part of a qualified distribution.

Also like a non-qualified annuity, there are certain penalties for early IRA withdrawals. Generally, to the extent includable in income, distributions from both traditional and Roth IRAs received before the IRA holder reaches age 59 1/2 are subject to a 10% penalty tax. Benefits which are paid out from a traditional IRA after this age has been reached are fully taxable, if all contributions to the IRA were made on a tax-deductible basis. If some contributions to a traditional IRA were deductible when made but others were not, a portion of each benefit payment will be taxable and a portion will not. Unlike non-qualified annuities, traditional IRAs require that the holder begin receiving distributions of at least a minimum amount at about age 70 1/2. In contrast, a Roth IRA is subject to minimum distribution requirements only upon the death of the owner.

From a financial planning perspective, it is important to note that for high income taxpayers who, because of their income levels, cannot take advantage of IRAs, the use of a non-qualified annuity to accumulate funds for retirement purposes can be attractive. While it is true that premiums paid into a non-qualified annuity are not income tax deductible and benefit payments from such an annuity will be partially taxable, there is no limit on the amount of funds that may be placed in a non-qualified annuity. And, of course, the interest earned on the funds inside the annuity is tax deferred.

Qualified Retirement Plans

Generally, a qualified retirement plan is an employee benefit arrangement offered by an employer to its employees that meets certain requirements set forth in the Internal Revenue Code. There are several different types of qualified plans including defined benefit plans and defined contribution plans, such as profit-sharing plans, 401(k) plans, and employer stock ownership plans.

It is important to understand that while these plans are designed to provide an employee with some type of benefit at retirement, most employees have little control over the type of plan offered by their employer or the manner in which the funds inside the plan are invested (with the exception of 401(k) plans). The non-qualified annuity offers a method of supplementing the employee's retirement income over which the employee retains a much greater degree of control.

Contributions made to a qualified retirement plan are income tax deductible to the employer making the contributions provided certain requirements are met. For example: In order to be qualified, a plan must meet certain nondiscrimination requirements; in other words, an employer generally must offer its qualified retirement plan to almost all employees. The employee does not pay any current income tax on the qualified plan contributions made on his behalf. The contributions are subject to income tax only when the employee begins receiving retirement benefits from the plan.

Most large corporations provide their employees with some type of qualified retirement plan. A few provide more than one plan. However, many small companies and self-employed individuals do not have sufficient income to make contributions to such a plan. Contributions to a non-qualified annuity by these individuals may provide their only source of retirement income, other than government benefits such as Social Security.

Tax Sheltered Annuities

A Tax Sheltered Annuity (TSA) – often called a 403(b) annuity, Panama not gain is yeah me too after the Code section authorizing such plans - is a special type of annuity that is available only to individuals employed in public schools and nonprofit organizations that are operated exclusively for religious, literary, charitable, scientific, or educational purposes. Included here are churches, synagogues, hospitals, and colleges.

A TSA is usually issued by an insurance company. It may be either a fixed or a variable annuity contract. Some companies are offering an equity-indexed annuity for use as a TSA. In certain instances, a limited amount of life insurance may be offered as part of the TSA arrangement.

To eligible individuals a TSA can provide a good retirement benefit and is usually something that the individual will want to take full advantage of. Contributions to a TSA are made by the employer on either a salary reduction or additional compensation basis. In other words, the employer can pay the TSA premiums by simply giving the employee that much additional compensation or the employer can require that the TSA premium come out of the salary already being paid to the employee. An employee may exclude from income TSA contributions that are made on his behalf, subject to certain limitations. Usually, the employee owns the TSA personally.

Similar to qualified retirement plans, TSAs generally must meet certain requirements as to minimum participation and nondiscrimination. There is a penalty tax equal to 10% of the taxable amount of the distribution that applies generally to TSA distributions received before the annuity holder reaches age 59 1/2. An individual generally must begin receiving benefits from a TSA at about age 70 1/2. The benefit amount from a TSA is generally fully taxable at the time it is received.

CHARITABLE PLANNING

Gift of an Annuity

There are occasions when an individual who has purchased an annuity finds that he would like to make a gift of either the contract itself or the funds held in the contract. There is no reason that an individual cannot make a gift of a non-qualified annuity contract, if that is his wish. However, there may be some unanticipated tax results.

If the annuity holder decides to surrender the annuity fully and make a gift of the funds, he will pay income tax on the amount received from the insurance company less his basis in the contract. Barring previous partial surrenders, his basis will likely be equal to the amount of premiums he has paid into the annuity. If the annuity holder is not at least age 59 1/2 at the time of the surrender, he may encounter the 10% penalty tax on premature distributions. After surrendering the annuity and paying the necessary taxes, the individual can make a gift of the cash he receives from the surrender. Generally, a gift of up to $14,000 per person (for 2014; this “annual gift tax exclusion” amount may increase over time due to “indexing”) can be made before any gift tax will be due.

If the annuity holder chooses, he can simply make a gift of the annuity contract itself. Doing so has the advantage of providing the person who receives the gift of the annuity contract with the advantage of the income tax deferral on the interest earned inside the annuity. However, if the gift is of an annuity contract issued after April 22, 1987, the person making the gift is treated as having received an amount equal to the cash surrender value of the contract at the time of the gift minus the annuity holder’s investment in the annuity.

If the annuity contract if did was issued prior to April 23, 1987, the tax treatment is quite different. At the time of the gift, there is no “taxable event”, but when the transferee surrenders the contract, the transferor must report as income the contract “gain” as of the date of gift. The transferee must report any subsequent gain.

Of course, once the gift of the annuity is completed, the new owner may choose to surrender the contract and obtain the cash immediately. Another option after the gift is made is for the new owner to annuitize the contract right away and begin receiving benefit payments. If the recipient of the gift selects this option, the benefit payments from the annuity are taxed under the general annuity rules, which call for the application of an exclusion ratio resulting in the taxation of a portion of each annuity payment.

One situation where the gift of an annuity becomes a possibility concerns a parent or grandparent who purchased an annuity as a means to accumulate funds needed for a child's or grandchild's college education. If the child either does not attend college or obtains the funds to pay the cost from another source, the annuity holder may wish to make a gift of the funds earmarked for college expenses. Another instance concerns a parent who purchased an annuity for retirement income, but at retirement finds that he does not need the income from the annuity and, perhaps for estate planning purposes, decides to make a gift of the contract.

Charitable Gift Annuity

As opposed to making a gift of an annuity, as discussed above, an individual can enter into a charitable gift annuity arrangement. There is no previously-purchased annuity contract in this instance. Generally, a charitable gift annuity is an agreement between a charitable institution such as a church or college and an individual who wishes to make a contribution to the charity. If an individual donates property to the charity under a charitable gift annuity, he receives an annuity from the charity for the remainder of his life.

There is no transfer of an annuity contract; rather the annuity payments are made directly from the charity to the individual and are backed by the charity's assets and good name. The tax consequences of a charitable gift annuity can be complicated. There is usually an immediate income tax deduction for the person making the gift although the amount of this deduction may be limited.

Charitable Trusts

The field of charitable planning often involves intricate arrangements since large amounts of money and property are changing hands. There are several complex trust arrangements that are specific to the area of charitable planning. While an annuity is not usually a part of these types of trust arrangements, a planner or agent may find a very general understanding of these arrangements to be useful. A brief description of the charitable remainder trust, the charitable lead trust and the pooled income fund follow.

Charitable Remainder Trusts

A charitable remainder trust, or CRT, is a trust arrangement involving an irrevocable gift to a charity and payments for life or a term of years to an individual who is not a charity. At the beneficiary's death (or other termination of the trust) the property "remaining" in the trust becomes the property of the charity. Hence the name charitable remainder trust. The amount that must be paid out of the trust each year is at least 5% and not more than 50% of the net market value of the trust assets as mandated by the Internal Revenue Code; however the Code allows for some flexibility in design as described below. The requirements in the Internal Revenue Code for setting up and maintaining the CRT are detailed.

If certain requirements are met, the gift of property to the trust will result in an immediate charitable income tax deduction for the person making the gift.

There are two basic types of charitable remainder trusts: the charitable remainder unitrust (CRUT) and the charitable remainder annuity trust (CRAT).

A charitable remainder unitrust provides payment of a variable amount to a beneficiary who is not a charity with an irrevocable remainder interest to be paid to or held for the benefit of a charity. The payout must be a fixed percentage of not less than 5% and not more than 50% of the net fair market value of the trust assets and generally must be paid at least annually to the noncharitable beneficiary or beneficiaries. The remainder interest must equal at least 10% of the net fair market value of each contribution on the date it is contributed to the trust. However, a charitable remainder unitrust may be designed to pay out only its net income. It may (but does not have to) provide for payments not made in earlier years to be made up in later years. Since the trust is valued annually, the donor may make additional contributions to the trust.

In contrast, a charitable remainder annuity trust provides for payment of a fixed amount of at least 5% and not more than 50% of the initial fair market value of the assets at the time placed in the trust to the beneficiary that is not a charity. The remainder interest must equal at least 10% of the initial fair market value of the trust assets. Additional gifts are not permitted into the charitable remainder annuity trust since it is not subject to annual valuation.

In recent years, CRTs have been combined with several other arrangements. One of the more popular of these combinations is the CRT and the wealth replacement trust, a form of irrevocable life insurance trust. Typically such a plan calls for an individual to give appreciated capital gain property in trust to a charity, retaining the right to payment out of the value of the property for his life. Since the trust owns the property, it either holds onto it or sells it and reinvests the sale proceeds. The wealth replacement trust (so called since its purpose is to replace the wealth “lost” to the charity) owns a life insurance policy on the life of the person making the gift. The life insurance trust pays the premiums on the policy, finding these dollars, in theory, through the tax benefit of the charitable deduction to the donor from the gift of the property to the CRT. As mentioned above, at the termination of the trust the property remaining in the trust goes to the charity and the life insurance proceeds are paid to the beneficiaries of the life insurance trust. Typically, these beneficiaries are the family members of the person who arranged the CRT.

Charitable Lead Trusts

A charitable lead trust essentially reverses who receives the income interest and who receives the remainder interest with the charitable remainder trust. Here, it is the charity that receives the income or “lead” interest (hence the name charitable lead trust). The person setting up the trust (the donor) grants a right to payment to the charity, with the remainder interest in the property coming back to the donor or to beneficiaries he has named. The value of a gift of such an interest in property is deductible if certain requirements are met.

To meet these requirements, a charitable lead trust must be in the form of either a guaranteed annuity interest or a unitrust interest. A guaranteed annuity interest is the right to payment of a fixed amount, whereas a unitrust interest is the right to receive payment of a fixed percentage of the value of the

property placed in the trust. In either case, payments may be made to the charity for a period of time or over the life of an individual who is living when the trust is arranged.

Pooled Income Funds

A “pooled income fund” operates in the charitable marketplace in much the same manner as a mutual fund. A “pool” is formed, into which individuals (donors) may make an irrevocable gift of property that they wish to give to charity. Each donor then names a beneficiary to receive income from the fund, often for the beneficiary’s lifetime. The amount of income is generally determined by the rate of return earned by the trust. The charity receives the remainder interest in the trust property. The donor receives an immediate charitable contribution income tax deduction in an amount equal to the present value of the remainder interest, subject to certain limitations.

As with the charitable trust arrangements discussed above, a pooled income fund must comply with a number of requirements. One such requirement mandates that neither a donor nor a trust beneficiary may act as a fund trustee. There are also rules dealing with what types of investments a fund may own and particular rules regarding depreciable property.

COLLEGE FUNDING

Even before planning for their own retirement, the expense of providing their children with a college education is a primary concern for parents. Not all children go to college and, of course, some who do attend are fortunate enough to be awarded scholarships. However, no parent wants to think that his or her child might not be able to go to college solely because of a lack of funds. The cost of a college education has increased rapidly in the last few years. Currently, the cost to attend four years at a private college can run as high as $120,000 while the cost of four years at a state university runs about $30,000.

Over recent years, as annuity sales have increased rapidly, there has been much discussion over the use of non-qualified annuities as a vehicle to assist parents in accumulating funds to meet college expenses. In some instances, the annuity can be a useful tool. However, it is not always the best answer to the college funding dilemma.

The major advantage in using an annuity for this purpose is that the funds placed in the contract accumulate on a tax-deferred basis. In other words, the annuity holder does not pay income tax on the interest earned on the annuity funds until the funds are withdrawn from the contract. Since all the interest stays in the contract to accumulate even more interest, the tax-deferred annuity provides a greater rate of return, generally, than a financial vehicle that is not taxed on a deferred basis.

The primary drawback to using the annuity for college funding appears when it is time to take the funds out of the contract. There are several ways that an annuity holder can withdraw funds from an annuity including a full surrender, a partial surrender, or annuitization of the contract. If the annuity holder decides on some type of surrender, either full or partial, to withdraw the college funds, he will incur the 10% premature distribution penalty tax unless he is at least age 59 1/2. By the time that the parent pays

the regular income tax due on the surrender and then the penalty tax, the advantage gained by using the tax-deferred funding vehicle often is eliminated.

To illustrate, take the example of Mr. Black and his daughter, Sarah, who will be a freshman next fall. When Sarah was ten years old her father inherited a sizable amount of money from his uncle. He purchased a single premium deferred annuity with a premium of $20,000, naming himself as both the owner and annuitant. Today, Mr. Black is age 52 and the surrender value of the annuity is $31,877 assuming an interest rate of 6%. Since Mr. Black is younger than age 59 1/2, the 10% penalty tax will be applicable to any amounts surrendered out of the annuity. If he completely surrenders the contract, he will pay income tax on $11,877 which is calculated by subtracting his basis of $20,000 from the current annuity surrender value of $31,877. In addition to the income tax, Mr. Black will also owe a penalty tax equal to 10% of the taxable amount of the surrender. In this case, 10% of $11,877 is $1,188.

For the most part, the only way that Mr. Black can take funds out of the annuity contract before he reaches age 59 ½ without paying the penalty tax is to annuitize the contract over his life expectancy. Using the numbers in the example above, doing so would result in a monthly payment to Mr. Black of approximately $160 or $1,920 annually. This amount would assist with college expenses, but in the four years that his daughter will incur the majority of her educational costs, this amount will probably not be sufficient.

If a parent is slightly older than Mr. Black and would be age 59 1/2 during the child's college years, the non-qualified annuity makes a viable choice for accumulating the college funds. In this instance, the annuity contract could be surrendered completely or a partial surrender made in each of the years that the child is in school could be made. The income tax would be due, of course, but the penalty tax would be avoided. Some quick subtraction shows that this course of action works well for a parent who is at least 42 years old when the child is born.

Of course, there is no requirement that the parent be the owner and annuitant of the annuity contract. One logical alternative that eliminates the age 59 1/2 problem is for a grandparent to be the owner and annuitant of the contract that will be used for funding a grandchild's college education. If the grandparents purchase an annuity contract when a grandchild is born and then make regular premium payments over eighteen years, there will likely be a significant sum accumulated to finance the education.

An aspect of this approach that is typically appealing to the grandparents is that they retain control over the funds right up until the time that the grandchild begins college. There is no opportunity for the funds given to the parents to pay for a college education to be used for other purposes. Also, the funds will not be dissipated if the grandchild's parents divorce before the grandchild is college age.

If it is the grandparents or other family members that pay the college expenses, (whether an annuity is involved or not) there may be gift tax implications. In other words, the payment of the expenses by the grandparent will likely be considered a gift from the grandparent to the grandchild. Current tax law provides that up to $14,000 may be given to one individual by another each year without any gift tax being due. Thus, at least the annual gift tax exclusion amount could go to the grandchild each year

without the grandparent incurring any gift tax. If both grandparents join in the gift, this would allow $28,000 (or twice the current gift tax annual exclusion amount) to be given to the grandchild without gift tax being due. If the amount needed for one year exceeds this, the grandparent might make an additional gift to the grandchild's parents (who would each be able to receive the annual gift tax exclusion amount per year) and avoid gift tax in this manner.

Another gift tax exclusion exists for gifts made directly to an educational institution for "qualified educational expenses" on behalf of a relative such as a child or grandchild; there is no dollar limit on such excludable educational expense gifts.

BUSINESS PLANNING

There are several uses of annuities within the context of a business. The first is discussed above generally under the heading of retirement planning and more specifically below.

Retirement Planning

For a self-employed individual, the use of a non-qualified annuity may provide the only source of retirement income, other than government benefits such as Social Security. Many small business owners spend the early years of their careers struggling to get the business started and do not have the income to contribute to a retirement plan. In the later years of the business, the business owner may decide against putting in a qualified retirement plan since he would have to provide benefits for most, if not all, of the company's employees.

Thus, it is not unusual for a 60 or 65 year-old owner of a successful business to approach retirement age without the prospect of income coming from any source other than the continued existence of his business. If the business owner had purchased an annuity at the point where his income level from his business could support even a modest monthly premium payment, his retirement income would be enhanced. Many agents and financial planners find that a business owner who has just purchased an individual disability income policy is interested in beginning his retirement planning also.

To illustrate the difference in retirement income that this use of an annuity might make, take Mr. White, the sole owner of a dry cleaning business which he started 30 years ago at the age of 20. From a single store, Mr. White's business has grown to 20 locations spread through three cities. He has a substantial income today at the age of 50 but has never taken a systematic approach to his retirement planning. He is not interested in putting in a qualified retirement plan. If he simply purchases a non-qualified annuity contract for himself and contributes a monthly amount of $300 until he reaches age 65, he will have accumulated approximately $88,000 in his annuity, assuming an interest rate of 6%. If he annuitizes the contract using a life income settlement option, he will receive approximately $588 each month for the remainder of his life.

One question that most small business owners ask about this type of approach is whether the business can pay the premium and, if so, whether the business can take an income tax deduction for the premium payment. With a non-qualified annuity, there is no income tax deduction available for the

premiums as they are paid into the annuity. This is true no matter who pays the premium, Mr. White or his company. There is no reason why the business cannot pay the premium, but there is no particular advantage to doing so. If the business does pay the premium on an annuity that is owned personally by an employee-shareholder, the amount of the premium payment will be considered income taxable to the employee-shareholder as additional compensation. A deduction from income will be available to the business for this compensation amount as it would be with any reasonable salary payment made to an employee. But, there is no special deduction available simply because the business pays the premium on a personally-owned annuity.

Another question that frequently arises with this planning technique is whether the business can or should own the annuity. Since the Tax Reform Act of 1986, the answer to this question is almost always no. Although there is nothing to prohibit a corporation from owning a non-qualified annuity, there is a disadvantage from an income tax viewpoint. The “nonnatural” person rule applies to annuities owned by corporations and states, basically, that if any contributions are made after February 28, 1986, to a deferred annuity contract which is owned by a corporation or other entity which is not considered under the tax law to be a natural person, the interest earned each year on the funds inside the annuity is taxable. In other words, the advantage of income tax deferral is lost for annuities owned by corporations.

Non-qualified Deferred Compensation Plans

Prior to enactment of the Tax Reform Act of 1986, annuities were often used as a funding vehicle for non-qualified deferred compensation plans. The enactment of the “non-natural” person rule has made this practice *possibly* less attractive from a income tax point of view.

As mentioned above, the nonnatural person rule states that if any contributions are made after February 28, 1986, to a deferred annuity contract which is owned by a corporation or other entity which is not considered under the tax law to be a natural person, the interest earned each year on the funds inside the annuity is taxable. The *possible* loss of the tax deferral on the interest earned on the annuity should be a concern to be addressed by anyone considering this strategy. The IRS has, in several private letter rulings, held that deferred annuity contracts owned by corporations as informal funding instruments for deferred compensation plans would enjoy tax deferral as the corporations, in those particular cases, were acting as "agents of a natural person" (the employee for whose benefit the deferred compensation plan exists).

Sale of a Business

Often, as a business owner approaches retirement age, he realizes that the only source of retirement income available will be Social Security. With the realization that he will not be able to quit working, the business owner often looks toward the sale of all or perhaps only a portion of his business.

If a business is sold, the former owner may find himself in possession of a large amount of cash. Since these funds are intended to finance the owner’s retirement years, a non-qualified annuity is often a good place to put the cash generated by the sale of a business interest. Frequently, a business that was

largely dependent upon the efforts or special talents of the owner will be sold for a small purchase price with the former owner agreeing to act as a consultant for several years and receive either a salary for his efforts or a percentage of the company's sales or profits. If this is the case, a deferred annuity will be able to accept not only the initial purchase price but a portion of the amount that the former owner receives in each subsequent year.

Take the example of Mr. Brown, who owns a successful insurance agency. As he approaches age 65, Mr. Brown agrees to sell the agency to two individuals. Since many of his large accounts are personal friends and might not stay with the agency without his presence, Mr. Brown agrees to work for the new owners for a period of five years in return for a percentage of the commission earned by the agency each year. The initial purchase price paid to Mr. Brown is $25,000, an amount which could be placed in a variable annuity. In each of the next five years, he could place a part of the salary he earns from the new owners into the same variable annuity contract. At the end of five years, when he is 70 years old and ready to retire completely, Mr. Brown could annuitize the variable annuity contract, selecting a life income settlement option, and receive a check each month for the remainder of his life. If Mr. Brown should die prior to the end of the five year period, his beneficiary under the annuity contract would receive a death benefit equal to at least the amount of money that had been invested in the annuity contract up to the time of Mr. Brown's death. At age 70, the accumulation value of the annuity would provide Mr. Brown with a monthly income for life of $895.

Bonus Plan

Occasionally, an annuity is used in place of a life insurance policy in a type of non-qualified employee benefit plan referred to as a Bonus Plan or a Section 162 Bonus Plan. Although this type of plan is not a true "plan" it does provide a benefit. Under a Section 162 Bonus Plan, a corporation selects certain employees, usually top-level executives, to receive a salary increase or bonus.

This salary increase is deductible from income by the corporation under Code section 162 (hence the name of the plan) and must be included in income by the employee. Once the increase is in the hands of the executive he uses the amount to pay the premium on a life insurance policy insuring his life and owned by him personally.

Although a life insurance policy is usually used in this type of plan, an annuity may be substituted in certain instances such as when the executive cannot purchase insurance (i.e., is uninsurable) due to health problems.

ALTERNATIVES TO ANNUITIES

The primary use of a non-qualified annuity is to accumulate a sum of money that will be paid out over a certain period of years, often over the lifetime of the annuity holder. Although the annuity does offer certain advantages, it is not the only method by which a sum of money can be accumulated or paid out.

In addition to the other retirement planning vehicles discussed earlier (IRAs, qualified retirement plans, and TSAs), other financial tools used to accumulate funds for some future purpose include bank savings

accounts, certificates of deposit, and mutual funds. The characteristics of these additional alternatives are summarized below.

Bank Savings Account

A savings account at a bank, savings and loan, or a credit union is simply an account which holds money for the depositor. Periodically, the bank credits interest at a pre-determined rate on the funds in the account. A true savings account does not offer any check-writing privileges. The account holder must go to the bank and make a withdrawal in order to obtain funds from the account. (Of course, the withdrawal may be made at an automated teller machine or electronically over the phone also.)

A savings account is generally considered a safe place to keep funds, since banks do not usually invest in financial arrangements that carry a large degree of risk. In addition, deposits in many banks are insured by the Federal Deposit Insurance Corporation (FDIC) or a similar state institution.

Although a savings account is a low-risk financial vehicle allowing easy access to funds without penalty, interest earned on the savings account funds is taxed to the account holder at the time it is earned. The savings account does not allow deferral of the tax until the funds are withdrawn, as does the non-qualified annuity.

For example: If Mrs. Green places $5,000 in a savings account earning interest at the rate of 3% for one year, the interest credited to her account must be included in her taxable income in the year it is paid. Assuming that Mrs. Green makes a withdrawal from her account in an amount equal to the tax due on the interest earned, in the next year interest will be credited on the $5,000 plus the interest remaining after the tax was withdrawn. This is in contrast to an annuity, where the interest on Mrs. Green's $5,000 would not be taxed in the year it was credited and would remain in the annuity to be credited with interest during the next year. In other words, a savings account effectively earns interest on the prior year's interest less the tax due while an annuity earns interest on the full amount of the prior year's interest. Over a number of years, this difference in the timing of the taxation can result in a significant difference in accumulation. Of course, most annuities do place restrictions, in the form of surrender charges, on the accessibility of funds placed in an annuity.

From a financial planning perspective, placing funds in an annuity to the exclusion of placing funds in a vehicle such as a savings account that offers immediate and penalty-free access to the funds is not a recommended course of action. Many financial planners counsel their clients to keep an "emergency fund" equal to three to six months' income in a savings-account type of fund. The emergency fund should be well-established before funds are channeled into less accessible vehicles such as annuities.

Certificates of Deposit

In contrast to the easy accessibility of a savings account, funds placed in a certificate of deposit, or CD, are available only at maturity without penalty. A CD is a vehicle, offered by a financial institution, into which an individual places funds for a certain length of time and, in return, receives interest at a set rate. The interest rate is usually slightly higher than the rate of interest paid on a savings account and,

often, the financial institution will require a minimum amount to purchase a CD. If a CD holder wishes to withdraw all or a portion of the CD funds prior to the end of the CD period, usually a certain portion of the interest earned on the funds will be forfeited to the bank.

Most banks and other institutions offer CDs for various lengths of time and, usually, the longer the time frame, the higher the interest rate that the CD holder will receive on his money. For example: A six-month CD might pay interest at 3.5% while a 24-month CD pays interest at a rate of 3.75%. The bank is willing to pay a slighter higher rate since it anticipates having the use of the funds in the 24-month CD for a longer period of time.

From an income tax perspective, CDs are taxed like savings accounts. The interest earned is taxed in the year in which it is credited to the CD.

Mutual Funds

A mutual fund operates as a pool into which investors may place their funds. The mutual fund issues each investor a certain number of shares according to the amount of his investment. Then the mutual fund invests all the funds from all its investors in the various investment vehicles available in the financial marketplace. By pooling their funds, the investors in a mutual fund create a much larger amount of money to invest than any single investor could muster. This allows the mutual fund to diversify its investments to a much greater extent than could a lone investor and, thus, lessen the risk to all investors.

There are many different types of mutual funds, some investing in only one type of investment such as growth stocks, some investing in a single industry such as health care and some offering a "family" of funds each with a different emphasis. Most funds, known as open-ended funds, will buy an investor's shares in the fund back at any time, making this type of investment a fairly liquid one.

Many funds charge investors a fee which consists of a stated percentage of the investors's account, a flat fee, or both. There are a significant number of funds that do not charge fees, called "no-load" funds. "Load" is another term used to describe a fee.

Returns from a mutual fund must be reported as taxable income by the investor currently. There is no income tax deferral offered by most mutual funds. Mutual funds may be purchased under the umbrella of a variable annuity.