

ROAD TO SECURITY

How to ditch an annuity and perhaps save on taxes

By Julie Jason, Columnist

Are you stuck with an annuity you don't want or need?

Not necessarily.

Let's go through an illustration to explore some possibilities.

John, 66, receives \$7,566 per month from an immediate annuity he purchased four years ago for \$1.1 million. The annuity is guaranteed to pay the monthly payment to John (or his beneficiary) for a period of 20 years, and so far, John has received 46 of the 240 monthly payments due to him.

John no longer needs the income and instead would like to leave money to his heirs.

Can John go back to the insurance company that issued the annuity and ask for a refund? No. Once the decision is made to enter into a 20-year-certain income stream, there is no turning back. Unless the annuity contract provides an out, there is none.

Is there another option?

"You may be surprised to learn that you may be able to sell your annuity," said Michael Vaughan, managing director of the Annuity Purchase Program of J.G. Wentworth of Bryn Mawr, Pa.

Since John is due to receive another 194 monthly payments of \$7,566, he has something of value that he can sell through companies like Wentworth, who helped establish the secondary market in annuities more than 15 years ago.

After considering his options, John sold \$4,000 of his \$7,566 monthly payment for \$448,910 and kept the remaining \$3,566 per month for himself. He was advised that he could use the proceeds of the sale to buy a life insurance policy with a \$1.65 million death benefit.

Typically, the insurance policy would be purchased by an insurance trust, and

a gift tax return would be filed for the \$448,910 gift to the trust. But since that amount is less than the \$1 million lifetime gift tax exclusion, there would be no gift tax.

The sale is a taxable event, but, as in many cases such as this, there was no tax due. Let me explain. The proceeds of the sale are compared to the cost basis of the portion of the payments sold. The cost basis is the amount John would have received over time had he not sold that part of the annuity.

In this case, the proceeds are less than the cost basis, which means there is no tax due on the sale. This is not uncommon. Typically, an immediate annuity sale does not result in a gain. (Tax-deferred annuities are a different matter.)

"In fact," said Bob Scharin, senior tax analyst from Thomson Tax & Accounting, "The sale can result in tax savings when there is a loss. The loss is reported on line 14 of Form 1040 (as a negative number) and reduces your taxable income dollar for dollar."

You also need to attach Form 4797 called "Sales of Business Property." A section of that form applies to annuities, Scharin said.

Let's consider the effect of an immediate annuity on estate taxes should John die before receiving the remaining 194 payments. Assume John's estate is above the current \$2 million threshold for the maximum federal tax-free estate transfer.

An annuity, while it bypasses probate and goes directly to the beneficiaries, is still considered to be part of the estate for the estate transfer tax calculation. How is the annuity stream valued for estate tax purposes? A present value calculation. Let me explain by looking at the values before and after the sale.

Assume that John did not sell any part of the annuity. The present value of the remaining 194 payments of \$7,566 is about \$1 million for estate tax purposes, assuming a 5 percent present value interest factor, Vaughan said.

If you figure a federal estate tax of 46 percent, the beneficiaries would owe more than \$450,000 in estate taxes for the annuity alone, he said.

While the annuity would continue monthly payments to the beneficiaries for the remaining period, those payments would not be usable to pay off the estate tax obligation.

The beneficiaries would have to raise the money for taxes some other way or sell the annuity in the secondary market just to cover the estate tax obligation.

Take the alternative solution, whereby John retains 194 monthly payments of \$3,566 and sells the rest.

The present value of the retained portion would be about \$470,000 using the 5 percent interest we assumed above, resulting in estate taxes of more than \$200,000, Vaughan said.

John's heirs could be ahead by more than \$1 million if John sells the annuity as shown in this example.

"The need for liquidity, flexibility and new solutions is driving this market," Vaughan said. "This type of solution is possible because the secondary market takes a previously illiquid asset and makes it liquid again."

"If you are considering a sale such as this, be sure to review your income tax and estate tax consequences with your tax adviser," Scharin said.

- Julie Jason, JD, LLM, a money manager and principal of Jackson, Grant Investment Advisers Inc. of Stamford, welcomes questions for consideration in her column. E-mail her at JJ@JulieJason.com or write to her c/o The Advocate and Greenwich Time, 75 Tresser Blvd., Stamford, CT 06904.

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