GETTING DIVORCED WHILE YOU OWN AN ANNUITY? BE VERY, VERY CAREFUL

Divorce attorneys may know family law, but they typically know little about tax law - especially when it comes to annuities. Millions and millions of dollars of wealth is unnecessarily destroyed each year when a divorce leads to an annuity contract being divided as part of the divorce settlement. In the vast majority of cases, it is both parties that are equally impacted. The saddest part of all is that this wealth destruction can typically be easily avoided. If the right person asks the right questions, you and your ex-spouse can completely avoid any detrimental effects.

There is nothing in the tax code that dictates how an annuity should be divided in a divorce situation. Therefore, each insurance company is forced to adopt its own procedures. In general, the insurance company's first priority is to establish a procedure that is easy and limits their potential liability. Unfortunately, their solution is rarely what is best for the policyholder. The number one thing to remember is that virtually every insurance company treats the division of the annuity as a withdrawal from the original contract. By processing the division as a withdrawal, taxes can be triggered. In addition, policy death and living benefits can be severely impacted.

POSSIBLE TAX CONSEQUENCES

Unless a withdrawal is transferred to another annuity or retirement plan (if the annuity is currently funding a qualified retirement plan such as an IRA), it will trigger any deferred income taxes. The insurance company's internal rules will decide which spouse will be responsible for paying the taxes. In many cases, the insurance company will take tax reporting instructions from the court, but some companies will follow their own internal rules no matter what the court dictates. Fortunately, the taxes are relatively easy to avoid. In general, if the money "withdrawn" from the annuity on behalf of one of the ex-spouses is used to purchase another annuity from the insurance company that issued the original annuity, then no taxes will be reported. In addition, in every case we have found (thus far), no taxes will be reported as long as the "withdrawal" is transferred directly to another insurance company to fund another annuity.

AVOIDING TAXES IS NOT THE SAME AS MAINTAINING WEALTH

The fact of the matter is that the annuity you currently own could have features that no longer exist today. That is particularly true when it comes to variable annuities with living and death benefits. The combination of the 2007-2009 financial crisis and the low interest rates that exist today have caused the variable annuity companies to eliminate many of the features that were common on contracts issued prior to 2007. If those features still exist, then they most certainly will cost more to obtain and provide less lifetime income than the versions issued before 2007.

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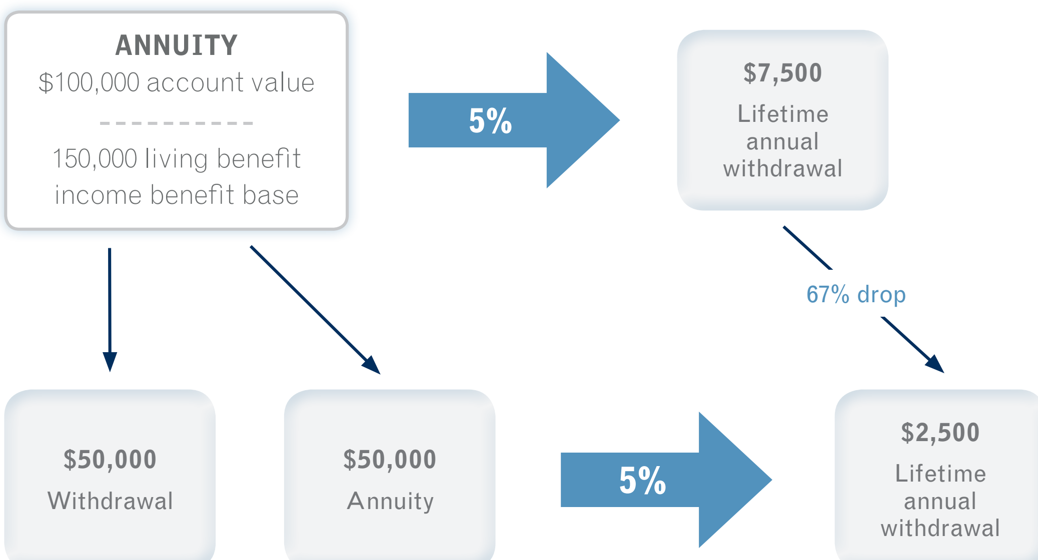
And this is not just the case with variable annuities. Most fixed annuities issued prior to 2007 have a 3% minimum annual rate of interest. Today's contracts typically have a 1% minimum rate. Therefore, while taxes can be avoided on any type of deferred annuity, by dividing the original contract and using the proceeds to buy another, the spouse that receives the "withdrawal" is likely to end up with an annuity that is greatly inferior to the original one. This inequity needs to be factored in when determining an equitable division of assets.

HOW LIVING BENEFITS CAN BE IMPACTED

The most common disposition of an annuity in divorce proceedings is to split the annuity in half. This is typically executed by withdrawing half of the account value and giving it to one of the spouses. In most cases, the other spouse is then left with the option of taking the other half of the annuity in cash, or maintaining the annuity with half of the previous value. Either solution will almost certainly impact the guarantees of any living benefit that is attached to a variable or indexed annuity, thereby reducing the wealth of both spouses.

Let's say for example that we have an annuity with a $100,000 account value and a living benefit with a 150,000 income benefit base (note again, that we have left off the "$" sign since this income benefit base is only used to calculate a level of income – it is not cash). Assuming the living benefit allows the policyholder to take 5% of the income base for life, this example would allow a lifetime annual withdrawal of $7,500. That's a very generous withdrawal rate on a $100,000 account value, especially in this interest rate environment.



This hypothetical example is for illustrative purposes only.

The court instructs the insurance company to give $50,000 to one spouse and let the other spouse keep the annuity that would be worth $50,000 after the withdrawal is made. Almost every insurance company would treat this as an excess withdrawal. Depending on the design of the living benefit, the income benefit base after the $50,000 withdrawal could be reduced to as low as 50,000, thereby reducing the lifetime income from $7,500 to just $2,500. In this example, the 50% withdrawal – a withdrawal that was made simply to reposition assets – leads to a 67% drop in potential income. Put another way, dividing the contract in half cost the spouse that was left with the contract $5,000 a year for life.

BEWARE OF THE IMPACT ON DEATH BENEFITS AS WELL

Virtually every variable annuity is issued with some kind of death benefit. Even a return of premium death benefit can provide significant extra value. It is not uncommon to find a variable annuity issued prior to 2008 that has a death benefit significantly higher than the account value. Dividing the annuity can impact the death benefit in much the same way as a living benefit.

For example, let's assume the account value of a variable annuity is $80,000, but the death benefit – the amount paid to the beneficiary upon the death of the owner – is $140,000. If the court instructs the variable annuity company to divide the annuity in half, then the insurance company will "withdraw" $40,000 from the annuity. If the contract was issued after 2002, the company will likely reduce the death benefit in half as well. That leaves a $40,000 annuity with only a $70,000 death benefit. Suddenly the $60,000 incremental death benefit is only $30,000.

THE BEST STRATEGY

In almost every case, the best strategy for both spouses will be to assign the entire annuity contract to one of the spouses and let the other spouse receive an asset of equal value. This simple approach will almost always avoid any pitfalls that can inadvertently result from splitting the contract in two. Of course, this means that a value must be put on the existing contract. If living and/or death benefits are attached, the true value can be much more than just the account value. Despite this, any knowledgable financial advisor should be able to properly value the contract.

The situation becomes a little more complicated if you and your spouse own more than one contract. In cases where clients own multiple contracts, it becomes an exercise in determining which spouse would maintain which contract. If you find yourself in this situation, pay close attention to the tax cost basis of any non-qualified variable annuities the client might own (this will not matter if the annuities are in a retirement plan such as an IRA). Depending upon when the variable annuity was purchased and how it has performed, it is possible that the value is worth less than the amount originally invested. In such cases, the cost basis for tax purposes would exceed the contract value. As backwards as it may seem, such a contract is much more valuable than a contract of similar value but a lower cost basis. For example, let's say a couple owns two variable annuity contracts, both worth $100,000. However, one contract was funded with $80,000 and the other with $120,000. While they have the same account value, if the contract that was funded with $80,000 is cashed in, the owner would have to report $20,000 in ordinary income. However, if the contract with $120,000 is cashed in, not only would there be no taxes due, but the owner would be able to reduce his or her ordinary income by the $20,000 loss. As an alternative, the owner could wait until the annuity value increases to $120,000 and cash it in with no taxes at all.

This material is not intended as tax advice. As federal and tax rules are subject to frequent changes, you should consult with a qualified tax advisor prior to making any investment decisions.