

Taxation of Annuity Contracts Held By a Trust

Under Internal Revenue Code Section 72(u), the non-natural person rule states that if an annuity contract is held by a person who is not a natural person the annuity is not treated as an annuity contract for tax purposes. If the non-natural person rule applies, the annuity owner loses the tax deferral associated with the deferred annuity.

Under the Tax Reform Act of 1986, when an Annuity contract is deemed to be owned by a non-natural person, it is no longer taxed as an Annuity. Any annual increase in the value of the annuity is taxed as ordinary income in the year the income is accrued or received and is taxable to the owner of the contract even if the income is not distributed.

However, the Tax Reform Act of 1986 created an exception to the non-natural person rule. The purpose of the rule was to eliminate corporations from receiving the tax deferred benefits of a deferred annuity that were meant for individuals. Corporations frequently used deferred annuity contracts to fund Deferred Compensation Agreements with top executives.

The legislative history of section 72(u) suggests that the focus of the exception for "holding by a trust or other entity as an agent for a natural person" was on beneficial ownership. The House Report, the Senate Report, the Conference Report, and the Joint Committee on Taxation Blue Book all provide that "[i]n the case of a contract the nominal owner of which is a person who is not a natural person (e.g., a corporation or a trust), but the beneficial owner of which is a natural person, the contract is treated as held by a natural person."

We then have PLR 9752035 which indicates that the beneficial ownership test still works. In this case, the decedent left his estate to a trust with all of the income distributed for the benefit of the life beneficiary. PLRs cannot be relied upon by anyone other than the taxpayer requesting the ruling but do provide an indication on the IRS's thinking.

The Trustees wanted to purchase a single premium individual deferred annuity contract, where the Trust would be the owner and beneficiary. The life beneficiary would be the annuitant. The life beneficiary and the remaindermen were natural persons. The Trustee sought a private letter ruling confirming that the annuity contract would be treated as held by a natural person with deferral of gains.

Relying upon the legislative history of section 72(u)(1), the Service stated that in the case of an annuity contract, the nominal owner of which was not a natural person, but the beneficial owner of which was a natural person, the contract would be treated as held by a natural person.

The Service concluded that under the facts presented, the ownership interest of the trust was nominal compared to that of the life beneficiary and remaindermen. Thus, the Service held that the annuity contract would be considered to be owned by a natural person for purposes of section 72(u)(1), under the facts presented.

Therefore, we can assure our clients that if the Trust is properly structured so natural persons are involved and the Trust is being held for the benefit of those natural persons, then it will qualify for the non-natural person exception.

Questions remain where there is one annuitant and multiple beneficiaries or when the beneficiary and annuitant are separate individuals. We see many trusts where they want to make the Trustee the annuitant and we do not permit such an arrangement. If the transaction is simple it works fine but if a party tries to not follow the circumstances outlined in the law and PLRs, the results may be adverse to your client's best interests.

If you have questions about this article, please contact:

Robert W. Schefft, JD, CFP, Vice President, Advanced Sales and Marketing,

**888-504-2550 ext 5767,
or via e-mail at bob.schefft@anico.com.**

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