



April 2007

## Underwater Annuities

### Navigating unrealized annuity losses

With the coming of April, a few events usually come to mind: blooming flowers, freak snow falls (in that order) and paying taxes. While we don't claim to be experts in the laws of nature, we know a little something about the (tax) laws of Congress. For instance, when making investment decisions, taxpayers should always focus on tax efficiencies and (legal) tax avoidance & deferral strategies. One such strategy/product we occasionally see pitched to the investing public are tax deferred annuities (TDA). Now we've never been huge proponents of annuities, but bashing them will not be the focus of this month's *Fiscal Fitness*. Rather, we'll address the rising number of investors sitting on annuities with unrealized losses and suggest a few remedies.

First, while annuities can be confusing, expensive and over-marketed, they can also be appropriate in situations where the investor wants to defer taxes on income and/or lock in investment returns (fixed annuity). Just know what you are buying. Unlike many investments, annuities are contracts and there's a cost to liquidity. We've seen more than one instance of investors thinking they owned a mutual fund when actually it was a variable annuity. There's a huge difference in surrender charges and taxation. Let's look at an example on the taxation of an annuity when you've incurred a loss in principal.

*Jackson, age 49, bought a variable annuity (outside his IRA) right at the 2000 market peak 7 years ago for \$100,000. It is now only worth \$85,000. The good news is he is beyond the annuity's surrender charge period so he will incur no penalty for terminating the policy. But he's worried that because he is under age 59 ½ he will get hit with IRS penalties and taxes. Short of kicking his dog, what can he reasonably do?*

To his surprise, Jackson has a few viable options:

- A. He could surrender the policy and move the proceeds via a 1035 exchange into a no-load annuity. While there would be no IRS penalties/taxes, the loss would not be deductible and would follow him to the new annuity. This might improve his investment but any tax benefit would be also be deferred.
- B. Jackson could surrender the policy altogether and realize the loss without penalty or taxes. There are a few different avenues to approach this – from conservative to aggressive.
  - While you might think this is an investment (capital) loss, it's actually a more attractive *ordinary* loss. How to file this gets a bit trickier:
    - a. Conservative filers can file the loss as a miscellaneous deduction on Schedule A. But you can only deduct the portion of the loss that exceeds 2% of adjusted gross income. For high income earners, a portion or all of the loss would be disallowed. Additionally large miscellaneous deductions can trigger the dreaded Alternative Minimum Tax. (Explaining that pain is beyond the scope of this letter but not beyond the scope of our expertise)
    - b. A more aggressive approach would be to take an ordinary loss on Form 4797, and then move that Form 4797 number directly to the front of your tax return under "other gains or losses." This method lets you deduct the full loss without a 2% haircut. Additionally, you'll have no AMT issues, and the loss will help to reduce your AGI, which might help you in other ways.<sup>1</sup>

The IRS has stated no firm guidelines when deducting annuity losses so whichever approach you take, it is likely defensible. As with any sensitive tax issue, talk to a competent tax advisory. Most investors didn't realize they could deduct the loss. So if you're sitting on a sinking annuity, there may be a financial lifeline.

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<sup>1</sup> IRS Revenue Ruling 61-201 and 72-193.