The National Underwriter Company

Expert's Corner:

WHOSE DEATH TRIGGERS *WHICH* DEATH BENEFIT IN THAT ANNUITY?

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One of the benefits of a deferred annuity (an annuity contract in which regular annuity payments need not begin in the first year) is tax deferral (annual increases in cash value are not taxed as earned, but only when distributed). But this tax treatment may not continue in perpetuity; the contract value must be paid out as a death benefit when someone dies. But who is that someone? And which death benefit (for a contract may provide for more than one death benefit) will be paid? The answer to both questions is "it depends on the type of contract".

"Owner-Driven" vs. "Annuitant-Driven"

With regard to when a death benefit will be paid, there are two types of deferred annuity contracts. "Annuitant-driven" contracts will pay a death benefit upon the death of the primary annuitant[1]. "Owner-driven" contracts pay a death benefit upon the death of the contract owner (who may not be the primary annuitant). This would likely lead a normal English-speaking person to conclude that any given deferred annuity contract is either one or the other. That would make sense, but it's not the case. In fact, *all* deferred annuity contracts issued since January 18, 1985 must be paid out upon the death of any owner because IRC Section 72(s)(1)(B) requires it. *Some* deferred annuity contracts are also annuitant-driven (that is, they will pay out upon the death of either an owner or the primary annuitant).

As if this were not complicated enough, the amount of such payout could be different if the contract provides a *guaranteed minimum death benefit*. Although conventional fixed deferred annuity contracts typically provide for only one death benefit (the cash value – which may or may not be subject to surrender charges), *indexed* and *variable* deferred annuities often contain a *guaranteed minimum death benefit* that may exceed the cash value. Thus, the amount paid out at death will depend upon (a) the identity of the decedent (was it the *annuitant* or *an owner?*) and (b) whether the contract provides for a guaranteed minimum death benefit.

Obviously, none of this is relevant if the owner and annuitant are the same individual, but this is not always the case. Sometimes, the owner and annuitant must be different parties (e.g.: where the annuity is to be owned by a trust, which, not being a human being, cannot be the annuitant). Sometimes, the owner and annuitant are different parties because the individual named as owner could not be named as annuitant (e.g.: some insurers will not issue a deferred annuity on an annuitant over a certain age, but will permit that person to be the owner, so long as a younger person is named as annuitant).

When possible, the author strongly suggests that the owner and annuitant be the same individual, to avoid confusion. When this is not possible, or where there are good reasons for naming, as contract owner, someone other than the primary annuitant, everyone involved should understand what amount will be paid upon the death of either party.

Examples: NOTE: These examples assume that the contract is a deferred annuity where death occurs prior to the Annuity Starting Date. Immediate annuities and deferred annuities where death occurs on or after the Annuity Starting Date (that is, where regular annuity payments have already commenced) must be paid out "at least as rapidly as" the owner or annuitant was receiving them.

1. George owns an annuity that provides for payment upon the death of the annuitant (that is, the contract is "annuitant-driven"). George's wife, Gracie, is named as *annuitant*.
   a. If the contract includes a *guaranteed minimum death benefit*,
      i. Gracie's death will trigger payment of that guaranteed minimum death benefit, because the contract is annuitant-driven.
      ii. George's death will trigger payment of the contract's cash value (which may be less), because IRC Section 72(s) requires same.
   b. If the contract does not provide for a *guaranteed minimum death benefit*,
      i. Gracie's death will trigger payment of the cash value (the "regular" death benefit, there being no guaranteed minimum death benefit other than the contract's cash value), because the contract is annuitant-driven.
      ii. George's death will trigger payment of the contract's cash value, because IRC Section 72(s) requires same.

2. George owns an annuity that provides for payment upon the death of the *owne*r (that is, the contract is not "annuitant-driven"). Gracie is named as annuitant.
   a. If the contract includes a *guaranteed minimum death benefit*,
      i. George's death will trigger payment of that guaranteed minimum death benefit.
      ii. Gracie's death will trigger no payout. George can simply name a new annuitant. (Many contracts will, in that situation, cause George, as owner, to become the new primary annuitant).
   b. If the contract does not provide for a *guaranteed minimum death benefit*,
      i. George's death will trigger payout of the contract's cash value.
      ii. Gracie's death will trigger no payout (as above).

When A Deferred Annuity Is Owned By A Trust

Here, the rules are even more tricky, and are, in some cases, unclear. The required payout in this situation depends upon whether the trust is a grantor trust, and, if so, whether the primary annuitant named in the annuity is grantor of that trust.

The general rule is that where a deferred annuity is owned by a non-natural person, the primary annuitant shall be deemed to be the "holder" (owner) of the annuity (IRC Section 72(s)(6)(A)). However, when the trust owning the annuity is a grantor trust, the rules are unclear because the required post-death distribution rules of IRC Section 72 are not entirely consistent with the "grantor trust" rules of IRC Sections 671-679.

Where the trust owning the annuity is a grantor trust, the grantor will be considered owner of the annuity. Thus, the grantor's death will trigger payout of the annuity. However, what if that grantor is not the individual named as primary annuitant of the annuity? One expert in this area believes that, in that circumstance, the grantor's death will trigger payout[2]. At least one major insurer agrees, and will require payout upon that grantor's death. Yet another major insurer, following the rule of IRC §72(s)(6)(A), which declares that, where a non-natural person owns a deferred annuity, the primary annuitant shall be deemed to be the owner for purposes of required distributions at death, will require payout of the annuity upon the death of the annuitant.

How is a practitioner to know, when dealing with a deferred annuity owned by a grantor trust, whose death will trigger payout? The author suggests that, in that situation, the prudent advisor will get written confirmation, from the issuing insurer, as to that insurer's policy - ideally, before anyone dies.

If all of the above suggests to the reader that question of "whose death triggers which death benefit" is a murky one, the author agrees entirely. Indeed, some insurers, in structuring their deferred annuity contracts, have managed to make the answer to that question as difficult to answer as humanly possible. For example, one indexed annuity contains the following provisions:

If any owner who is also the annuitant dies, the death benefit will be paid to the beneficiary named in the contract.
But upon the death of "any owner who is not the annuitant", the contract value will be paid to the "designated beneficiary", which is not the beneficiary named in the contract, but, rather, "(i) the contingent owner named in the application, or as later changed, if any; or (ii) the joint owner or Owners in the case of joint ownership; or (iii) your estate if no contingent

owner is named, and there is no joint owner or Owners”.

What practitioner would expect such a result? Who would desire such a result?

The author strongly urges anyone who offers advice regarding a deferred annuity to be very sure that he or she understands what that contract says with regard to death benefits – specifically, whose death will trigger which death benefit. This will not necessarily be evident from the marketing material typically provided at the point of sale. You’ll need to read the contract!

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[1] The *annuitant* in an annuity contract is the individual (it must be a human being) who is the “measuring life” of the contract, the person whose age and sex (for sex-distinct contracts) determines the amount of each annuity payment.

[2] J. Gary Underwood, *Trust Ownership of Nonqualified Annuities: General Considerations for Trustees* (Journal of Financial Service Professionals, May, 2010).