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# Taking The Bite Out Of Annuity Losses

**by Steven Merkel,CFP®, ChFC (Contact Author | Biography)**

Are you stuck with an annuity that's lost more than half of its original value? You're probably not the only one. In the last two decades, the sales volume of variable annuities has seen phenomenal growth: skyrocketing from $4.6 billion in 1987 to $128.4 billion in 2004. Unfortunately, many investors who put large sums of money into annuities while the stock market climbed towards its peak in 1999 had no sense of the large losses they were about to face.

**The Rise of Variable Annuities**

In the 1990s, the New York Stock Exchange - where the stocks of about 3,000 companies are traded among investors each day - had the longest bull market in its history. With the S&P 500 averaging returns of more than 28% annually from 1995 through 1999, many investors wanted in on these extraordinary double-digit returns. Investors almost immediately lost interest in fixed annuities and started flooding billions of dollars into variable annuities in the hope of taking advantage of market-like returns offered by the mutual fund investments available inside a variable annuity. The ugly duckling of the investment industry had suddenly become the prettiest girl at the dance. (To learn more about fixed and variable annuities, see *An Overview Of Annuities*.)

The ability to have earnings grow tax-deferred within an annuity contract made this product attractive to those taxpayers seeking a tax break on their federal returns. Investors also placed great confidence in household names such as Fidelity, MetLife, Vanguard and Prudential, to name a few. For many people, the ability to invest in a product bearing one of these "tried and true" names made an annuity a desirable investment. Since annuities are often used to complement retirement plans and IRAs, it should come as no surprise that they too can provide different types of creditor protection in many states. According to state statutes, annuities are exempt from the claims of creditors in states such as Florida, Texas and Oklahoma, as long as the annuity was not acquired with fraudulent intent. This shelter provided by annuities made them an attractive investment for those concerned about asset protection.

**The Fall of Variable Annuities**

While many investors enjoyed the double-digit returns of the late '90s, many also suffered through the decline that followed in the ensuing three years. From 2000 through 2003, the S&P 500 lost an average 42%. An investor who purchased a $500,000 annuity in 2000, invested primarily in large U.S. companies, could have lost over $210,000 by the end of 2003. In fact, investors lost billions, and suddenly everyone was scared to death of the stock market. The sales techniques used by variable annuity salespeople were widely criticized and regulatory agencies grew concerned about annuity misrepresentation.

Knowledge of less-than-exemplary activities in the financial industry (lack of full disclosure and falsification of variable annuities) led to the rapid education of many investors, as they learned about surrender charges, fees and expenses and the liquidity associated with variable annuities. Then, to add insult to injury, the IRS reduced the federal capital gains rate down from 28% to 20%, and down again to the current 15%, while maintaining the ordinary income taxation of annuity profits (when withdrawn). Armed with their newfound knowledge and tormented by the large losses in their annuities, many investors were eager to shift their money out of variable annuities, but steep surrender charges made replacement tough.

So, what options are available to investors?

**Options for Your Underperforming Annuity**
***Surrender Your Annuity*:** Cash out of the annuity and use your funds for another type of investment. Make sure you call the annuity company first to verify if there are any surrender charges remaining on the contract.

***Full 1035 Exchange*:** 1035 exchange is a provision in the tax code which allows for the direct transfer of accumulated funds in a life insurance policy, endowment policy or annuity policy to another life insurance policy, endowment policy or annuity policy, without creating a taxable event.

***Partial Exchange*:** This option allows you to exchange a portion of the current annuity for another contract. This is commonly used to exchange the portion of the contract that has no surrender charge remaining. It allows you to keep your current annuity in force, thus maintaining the death benefit.

***Rollover to Another Investment Account*:** If a non-qualified annuity is underwater (current value is lower than your original cost basis), you can roll over the funds into another investment account, such as an individual brokerage account or a mutual fund account, without incurring a tax penalty. Surrender charges may still apply, so be sure to check with the annuity company first.

***Keep the Annuity*:** If your annuity is new, you're most likely still within the deferred sales charge period. Therefore, closing the annuity might not be the best option, since you might be hit with a hefty surrender charge. In this case, you may have to hold the annuity for a few more years for the surrender charge to go away, or take the punch and pay the deferred charge.

**Are Annuity Losses Deductible?**
For a non-qualified annuity loss to be tax deductible, the loss must be realized by completely cashing out or surrendering the annuity. Exchanges using the 1035 tax provision will not qualify the loss for a tax deduction; however, the new contract can maintain the original cost basis. It's important to remember that any surrender charges that apply will not be deductible as part of the realized loss.

***Example***
Let's say that Matt purchased a non-qualified annuity three years ago for $50,000. Due to poor investment performance, his annuity is now worth $40,000 and has a surrender charge of $3,000. Despite the surrender charge, Matt decides to cash out his annuity and receives a check for $37,000. Even though Matt received a check for only $37,000, his actual realized loss on the annuity is only $10,000, since the surrender charge of $3,000 cannot be counted as part of the realized loss as per IRS standards. However, even if Matt is not 59.5 years old, he will not be subject to a 10% IRS early-withdrawal penalty because this penalty is only imposed on gains.

Now that we've determined that Matt incurred a $10,000 realized loss, where should it be reported? Accountants have recently adopted two approaches to the reporting of this realized loss: an aggressive approach and a somewhat more conservative one. The conservative approach is to include the loss as a miscellaneous itemized deduction on Schedule A, where only the part of the loss that exceeds 2% of your adjusted gross income can be reported in this case (this may also subject you to the alternative minimum tax [AMT]). The more aggressive approach would have you take the position that the loss could be considered an ordinary loss sustained during the taxable year while entering into a transaction for a profit. In this case, the loss would be entered on Line 14 "Other gains & losses" (Form 1040 of a federal tax return), and the full loss could be deducted (without AMT issues).

**Conclusion**
The IRS Revenue Ruling 61-201 provides a minimal amount of authority for the idea that annuity losses would be acceptable as an ordinary loss (aggressive approach), but the safe gamble is to claim it as a

miscellaneous itemized deduction. Regrettably, the IRS has not given any firm guidelines as to the proper way to claim the loss. Most financial planners will take the position that an annuity loss is an ordinary loss directly reportable on the front of your federal tax form. However, it's usually best to let your tax accountant make the call, since this is undoubtedly a questionable area that could be challenged by the IRS.

In either case, there are potential benefits to surrendering or exchanging an underperforming annuity. Just be sure to consult with the annuity company prior to taking any action so that you'll understand the charges (if any) that are involved. As always, remember to maintain a long-term perspective with your investments - you don't want to burden yourself with an investment change today if it is not going to add value to your finances in the future.

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