

PRESENTATION – IRA ANNUITIES AS A NEW BAHAMIAN FINANCIAL PRODUCT

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A. Background

1. Over \$2.5 trillion in IRAs. Large amount from mega transfers from pensions
Consider Ken Lay? Could make small annual contributions in past (\$2,000) but might have huge commingled rollover amount in IRA.
2. Types: Traditional, Roth and Education. Discussion is of traditional only.”
3. Self-directed IRAs as large funds
4. Forms of holding: trust, custodial account, annuity.
5. Federal law protection from bankruptcy.¹ Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) generally makes it tougher for people to protect their assets in the event of personal bankruptcy. Under the new law, up to \$1 million of the assets held in traditional IRA or a larger amount determined by the bankruptcy court, will be exempt from bankruptcy estate. IRA assets that came from an employer retirement plan rollover—such as a 401(k), 403(b) or profit-sharing plan—are not subject to the claims of creditors, regardless of the state of residence or the value of rollover assets and their subsequent growth.
Advice to client: Keep pension rollover IRAs separate from traditional IRAs based on personal contribution.
6. Distributions are not protected by bankruptcy laws.
7. BAPCPA will not stop a divorcing spouse from taking a share of the IRA.
8. Compare qualified plan protection: Qualified retirement plans are protected under ERISA, which extends to judgments other than bankruptcy, regardless of state law. 100% under ERISA. Protections given to ERISA plans in the Supreme Court's *Patterson v. Shumate* decision have not been extended to IRAs.
9. Outside bankruptcy: State creditor laws vary greatly. Not every client is willing to take bankruptcy to avoid liability. Also, a court can reject a bankruptcy file and male fide and refuse it.

¹ When an individual files for personal bankruptcy, property owned by the individual generally becomes part of the individual's bankruptcy estate. However, certain property is either (a) excluded from the bankruptcy estate altogether, or (b) "exempt" from attachment under federal and state law. In either case (exclusion or exemption), the property remains outside of the reach of creditors. This determination is complicated by the fact that, under the terms of the federal Bankruptcy Code, individuals may exempt either (a) types of property included on a federal exemption list, or (b) types of property exempt under non-bankruptcy federal law or state or local law. The federal Code also permits individual states to limit bankrupt debtors to the second option, and most states have in fact "opted-out" of the federal exemption scheme. Therefore, different results can be achieved depending on the state in which the debtor resides.

B. Implication as to client profile.

1. Considering bankruptcy but has IRA over \$1 million, none of which from qualified plan rollovers, or is from such rollovers but sheltered part cannot be determined because of bad records.
2. Not willing to take bankruptcy and is from a state that offers little protection from creditors, exposing entire IRA.
3. Wants to slow creditors with hope of settling for pennies on dollar by throwing problem into Bahamas courts.
4. Can advise client that this has been done in the Bahamas already.

C. When can a foreign company handle an IRA?

1. Cannot legally handle an IRA trust or custodial account. Those must be American.
2. Foreign insurer can issue an Individual Retirement Annuity (IRAN).
3. Reasoning: IRC § 408(b) says an IRAN means an annuity contract, or an endowment contract (under Regulations), issued by an insurance company which meets the following requirements, all of which seem easy:
 - (a) The contract is not transferable by the owner.
 - (b) Under the contract—
 - (i) the premiums are not fixed,
 - (ii) the annual premium on behalf of any individual will not exceed the dollar amount in effect under section 219(b)(1)(A)², and
 - (iii) refund of premiums will be applied before the close of the calendar year following the year of the refund toward the payment of future premiums or the purchase of additional benefits.
 - (c) Under regulations prescribed by the Secretary, rules similar to the rules of § 401(a)(9) and the incidental death benefit requirements of § 401(a) apply to the distribution of the entire interest of the owner.
 - (d) The entire interest of the owner is nonforfeitable. There is more, but it seems inconsequential.
4. Is a Bahamas Insurer is an insurance company? Yes, because § 816, which defines the term “life insurance company” provides that it is an “insurance company” with special

² Currently \$4,000 per year or earnings, if less. It rises to \$5,000 in 2008.

characteristics. For this purpose, § 816(a) defines an “insurance company” as

“any company more than half of the business of which during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies.”

5. Reg. § 1.801-3 (a) provides further support for the idea that a foreign insurer is still an “insurance company”:

“(1) The term insurance company means a company whose primary and predominant business activity during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. Thus, though its name, charter powers, and subjection to State insurance laws are significant in determining the business which a company is authorized and intends to carry on, it is the character of the business actually done in the taxable year which determines whether a company is taxable as an insurance company under the Internal Revenue Code.”

D. Administration

1. Client transfers funds to insurer in exchange for annuity
2. Can be variable or fixed annuity
3. Decant or protector provisions? Perhaps.

Planning option: Suggest *Stretch IRA*. This is an IRA established to extend the period of tax-deferred earnings, typically over multiple generations. In the short run, client can use it to reduce required withdrawal client must take from the IRAN after she has retired or at least age 70 1/2, and will cut current income tax bill as well. Meanwhile, because client is extending IRA payout until grandchildren retire (or further, if appropriate), result is substantial additional deferral years to compound the earnings growth.

4. Forms: insurer provides customer with “disclosure statement” (boilerplate); files 5498 annually on owner, distributions, premiums, etc. plus 8606 and 1099R reporting distributions; fair market value statement as to what is in account; customer files 5329 in case of excise taxes on early or late distributions.
5. Withholding on distributions: none if client from SS number
6. Recordkeeping by insurer: see Reg. §35.3405-1T for array of record-keeping rules, the heart of which is that information to be retained

must be sufficient to prepare the required forms to be sent to the IRS and customer.

E. Estate taxes

1. An IRA account is reported on Schedule I of the decedent's estate tax return and is valued at the fair market value of the account's assets as of the date of death.
2. Once the money is withdrawn from the account, such amount is taxed to the estate or IRA beneficiary(ies) as income in respect of a decedent (IRD) either on the estate's income tax return(s) or the beneficiary's personal return(s).
3. Only annuities which continue to provide payments to surviving beneficiaries after the decedent dies are in the decedent's gross estate. If the decedent was receiving payments under a straight life annuity with no survivor benefit or refund feature at the time of death, nothing is included in the gross estate, because there is no continuing value in the annuity that passes to anyone else. It simply terminates. A decedent must have possessed the right to receive the benefits under an annuity contract payable to the decedent for: 1) his lifetime, (2) a period of time not ascertainable without reference to his death, or (3) any period which does not end in fact before his death. The annuity rules apply to survivor or death benefits payable under qualified retirement plans, 403(b) plans, 401(k) plans, IRAs and nonqualified deferred compensation plans, as well as commercial annuities.
4. Death or survivor benefits payable from IRAs or any type of employer retirement plan are reached by IRC § 2039, the section that deals with the estate taxation of annuities. This is true even if benefits have been arranged so that they are paid in a lump sum at decedent's death (rather than over time as an annuity).

Planning: Propose life IRAN for estate tax savings.