Virchow Krause & company

Tax Bytes

Tax Tips from the Virchow Krause Tax Team
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LOSS ON SURRENDER OF ANNUITY CONTRACTS

During the late 1990's, many people invested in variable annuities. Due to the recent bear market, the value of these investments is significantly lower than the purchase price. Consequently, the question arises regarding the ability to take a loss on this investment if the contract is surrendered.

First, you have to sell or "surrender" the contract. You may not exchange the annuity contract for another insurance product under Section 1035. To calculate your gain or loss, you have to figure your "cost" basis. This is the amount you paid for the contract minus any withdrawals you have made. From this you subtract the proceeds from the sale. If you have to pay a surrender charge, you must add this back to the proceeds.

For example, we assume you purchased a variable annuity for $100,000, you did not make any withdrawals, you have to pay a surrender charge of $5,000 and the annuity is worth $80,000 on the day you cash it in.

Even though you receive a check for $75,000, your loss is $20,000. The $5,000 is not considered part of your loss. Also, even if you are under 59 ½, there will be no 10% federal early withdrawal penalty because that penalty is only imposed on gains.

The unsettled area is where to report this loss on you tax return.

A loss on a variable annuity is not considered an "investment loss" to be shown on Schedule D with other capital gain and losses. It is classified as an ordinary loss.

The conservative approach is to treat the loss on the surrender of your annuity contract as a "miscellaneous deduction" on Schedule A, Form 1040. You will only get a deduction to the extent your total miscellaneous itemized deductions exceed 2% of your adjusted gross income (AGI).

Also, you must be careful of Alternative Minimum Tax (AMT). If you are subject to AMT, you would lose the ability to deduct ANY miscellaneous deductions.

However, a position can be taken to deduct the loss on line 14, Form 1040, "Other Gains/Losses). Revenue Ruling 61-201, 1961-2 CB 46, supports treating the loss as on ordinary loss. Under this scenario, you could deduct the full loss without being subject to the 2% limit. Furthermore, you would not have an AMT issue for this item.

As stated earlier, this is an unsettled area within the Tax Code and taking this loss as ordinary may be disallowed on audit. However, this Revenue Ruling provides substantial authority to take the loss.

For more information regarding this subject, please contact Robert S. Keebler, CPA, MST at 920-490-5626.

How a Loss on a Variable Annuity is Treated for Taxes

A loss on a variable annuity is deductible and ordinary as long as the person receiving proceeds from the sell or surrender of the annuity is the annuitant.

There are two options for how a loss can be taken:

1. Conservative: Reported on Schedule A as a Miscellaneous Deduction subject to the 2% of AGI floor and added back for AMT purposes.

2. Less Conservative: Other gain/(loss) without limit. This approach has some support from Revenue Ruling 61-201 which deals specifically with refund annuities.