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# Annuity Purchases for SERPs: Buy-Ins, Buy-Outs, and Settlement with Deferred Taxation

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## INTRODUCTION

Supplemental Executive Retirement Plans (SERPs) are non-contributory retirement income plans for executives. Like pension plans, SERPs are frequently defined benefit plans that pay regular benefits as long as the executive lives. Many provide joint and survivor options that allow some level of benefit to continue to surviving spouses, usually in exchange for lower benefits during the executive's life.

Annuities are insurance products that provide guaranteed lifetime income in exchange for a premium. Joint and survivor payout options are universal. Because annuities and SERPs both provide lifetime income, an annuity seems like a natural choice for financing a SERP. In fact, buying annuities to fund qualified pensions was common during the 1980's, and the market for annuities has enjoyed a limited resurgence.[1]

Given the uncertainty over future investment results and ever increasing life expectancies, the guarantees of an annuity contract have understandable appeal to employers that are considering financing a SERP or getting rid of the SERP entirely.

This article covers three arrangements that involve purchases of fixed annuities in the context of a defined benefit SERP sponsored by a for-profit corporation:

- Buy-ins
- Buy-outs
- Settlement with deferred executive taxation

For each arrangement, this article discusses tax considerations from employer and executive perspectives, accounting considerations, cost considerations, and other considerations (for example, proxy reporting). Readers should keep in mind that the issues for small employers may differ from the issues for large employers. For example, small employers may not work with an actuarial firm and may not benefit from the same institutional buying power of a large employer in the commercial annuity market. The discussion of each arrangement ends with a summary of pros and cons.

## BUY-INS

Some employers finance SERPs to improve benefit security, to establish a source of funds to pay the benefit, or to create investment income to neutralize the benefit expense. A buy-in is a SERP financing strategy that has no effect on executives, other than adding a degree of benefit security when a rabbi trust[2] owns the annuities. The employer purchases immediate annuities for executives who currently receive benefits (or will receive benefits within the next twelve months), but remains responsible for paying the benefits. For executives who do not yet receive benefits, the employer delays the annuity purchase until a date no earlier than twelve months before the first benefit payment. Tax law[3] discourages employers from buying deferred annuities (where payments begin more than twelve months in the future) which is discussed further in the Appendix to this article.

The annuity contract in a buy-in provides the employer with monthly cash receipts that equal the employer's monthly outlays for benefits under the plan on an individual by individual basis. The annuity contract eliminates both the employer's risk that poor investment performance will make earmarked assets insufficient to pay benefits and the risk that executives will live significantly beyond life expectancy. Purchasing the annuity contract does add a new risk: The insurance carrier could default on the payments under the annuity contract, while the employer remains obligated to pay the benefit.

**Tax Considerations**

In a qualified plan setting, the trust that holds assets for the plan can purchase an annuity, and the executive is not taxed until annuity payments are received. In this situation, the employer receives a tax deduction[4] for assets deposited in the trust to make the purchase. However, in a nonqualified buy-in setting, the employer (or the employer-sponsored rabbi trust) owns the annuity. The executive reports taxable income, and the employer takes a tax deduction,[5] as benefit payments are made.

When the owner and beneficiary of the annuity differ, ownership determines taxation. For example, the employer can own the annuity and designate the executive as beneficiary. In this case, the taxation is identical to the situation in which the employer is the beneficiary of the annuity and the employer pays the executive the SERP benefit. Because naming the executive as beneficiary does not relieve the employer of its obligation to withhold payroll taxes,[6] the insurance carrier must agree to withhold payroll taxes as discussed later in the section titled "Settlement with Deferred Executive Taxation."

**Example 1a**

Company A pays a premium of $1,666,667 for an immediate annuity with an annual benefit of $100,000 on an executive who has just retired with an annual SERP benefit of $100,000. The insurance carrier will withhold based on the retired executive's Form W-4 (and any state withholding if applicable) and pay the net amount directly to the executive. If withholding amounts change, the insurance carrier will adjust the split of the $100,000 between the withholding and the net benefit as appropriate. As owner of the annuity, Company A pays tax on any taxable income from the annuity just as if the insurance carrier had paid Company A and Company A had paid the executive. Arranging for the insurance carrier to act as Company A's agent in paying the executive does not change the taxation. As owner, Company A can change the beneficiary at any time, but remains obligated to pay the benefit either directly or indirectly. The executive remains a general creditor of Company A.

**Employer Taxation**

The premium for a corporate-owned immediate annuity is not deductible,[7] but the premium creates "investment in the contract,"[8] which reduces the taxable amount of benefit payments for the employer. An "exclusion ratio"[9] determines the non-taxable portion of each benefit payment. Most corporate-owned immediate annuities are fixed annuities, because benefits received under fixed annuities easily match to benefits paid under SERP obligations. For fixed annuities, the exclusion ratio equals the premium divided by the expected benefit payments, which equal the annual benefit payments times the life expectancy.

**Example 1b**

Company A from Example 1a purchases a single premium, immediate annuity of $100,000 per year on an executive age 65 for a premium of $1,666,667. Life expectancy from the IRS tables is twenty years.[10] The total expected benefit payments are $2,000,000 (twenty years at $100,000 per year). The exclusion ratio is 83.33%,[11] and $83,333 of each annual payment ($100,000 times 83.33%) is a tax-free return of the investment in the contract. The remaining $16,667 is taxable as ordinary income.

Once the cumulative excludable amounts equal the investment in the contract, all future payments are 100% taxable.[12]

**Example 1c**

Company A from Example 1b has fully recovered its $1,666,667 premium after 20 years ($83,333 per year for 20 years). Beginning at age 85, the $100,000 is fully taxable.

If the benefit payments stop before the owner of the annuity has recovered all of its investment, the unrecovered portion is deductible.[13] Tax law treats such losses as attributable to a trade or business for purposes of determining net operating losses.[14]

**Example 1d**

Company A from Example 1b receives $100,000 per year for 11 years, when the insured executive dies. Company A has recovered $916,667 ($83,333 per year for 11 years) of its $1,666,667 investment in the contract. The unrecovered portion of the investment in the contract is $750,000 and is deductible in the year of the executive's death.

Although employers that purchase an annuity with a benefit that matches the SERP benefit expect zero net cash flow in the future, tax rules create net tax savings. Even though the employer recognizes ordinary income on the annuity and deductible compensation expense on the SERP benefit, the deduction exceeds the taxable income when the annuity benefit equals the SERP benefit. Whereas an exclusion ratio limits the taxable portion of the annuity benefits, the SERP benefits are fully deductible at the time the executive receives the benefits (and reports the taxable income).

**Example 1e**

Company A in Example 1b deducts the compensation expense of $100,000 as the executive receives it but recognizes taxable income of only the $16,667. Company A's taxable income decreases by $83,333 until recovering the $1,666,667 investment in the contract after 20 years. Company A saves $33,333 per year by reducing taxable income by $83,333 each year at a tax rate of 40%. Beginning in year 21, the $100,000 annuity payment is fully taxable and the $100,000 benefit payment is fully deductible. The combined annual effect on Company A's taxable income is zero after year twenty.

**Employer as Owner, Executive as Beneficiary**

Some insurance carriers are willing to withhold the payroll taxes and pay the net amount directly to the executive. The employer owns the annuity but names the executive as beneficiary. The insurance carrier acts as the paying agent for the employer. The tax result is the same as when the employer names itself as beneficiary and uses the annuity proceeds to finance SERP payments to the executive.

**Matching After-Tax Cash Flows to Minimize Premium**

Employers that wish to match after-tax annuity cash flows to after-tax SERP cash flows could forgo the future net tax savings ($33,333 per year for 20 years in Example 1e) and purchase a smaller annuity. However, after recovery of the premium, the employer would then have net cash outflows because the fully deductible SERP payments would exceed the fully taxable annuity benefits.

**Executive Taxation**

Buy-in arrangements have no effect on the executive's taxes. Like SERP arrangements without annuity financing, buy-ins allow executives to pay income tax as benefits are received. The employer reports benefits paid on Form W-2 and withholds based on the executive's Form W-4.[15] The present value of the SERP benefits is included in FICA income no later than when amounts are reasonably ascertainable, usually at retirement.

**Accounting for Buy-Ins**

Understanding the accounting for buy-ins first requires an understanding of accounting for annuities and SERPs, and then requires an understanding of how to coordinate the accounting to achieve the most useful results for users of the financial statements.

***Accounting for Corporate-Owned Annuities***

Accounting guidance for annuity policyholders is scant. As an insurance contract, Accounting Standard Codification (ASC) Subtopic 325-30, Investments in Insurance Contracts, might apply,[16] except that Subtopic 325-30 recommends recording insurance contracts at cash surrender value.[17] Because immediate annuities have little or no cash value, the cash surrender value method understates the value of the asset. The fair value option under Subtopic 825-10 is the better approach. Refer to the Appendix for a discussion of fair value in the context of taxation of corporate- owned deferred annuities. Many of the fair value issues for tax purposes apply to fair value[18] issues for accounting purposes. Although guidance under Topic 820 suggests that replacement cost[19] might be a valid approach to establishing fair value in the absence of other “inputs,” replacement cost is a maximum value because of a potential buyer’s concerns over adverse selection (discussed in the Appendix). A retirement actuary is probably the best source for establishing an estimate of the fair value of an annuity.

Changes in the fair value of an immediate annuity reflect two primary factors: interest rates and life expectancy. When interest rates rise, fair values fall and vice versa. As the insured executive ages, the expected age at death increases. For example, an executive age 65 might be expected to live 20 years to age 85. An executive already age 85 might be expected to live seven years. The value of those additional seven years is reflected gradually each year as the executive ages. Annuity premiums reflect not only the attained age of the applicant but broad assumptions of future mortality experience on the general population insured under such products.

Example 2a illustrates an annuity’s fair value gain that results from persistency (that is, the survival of the insured executive.

**Example 2a**

Company A (from Example 1) purchases a single premium, immediate annuity of $100,000 per year on an executive age 65 for a premium of $1,666,667. Five years later the fair value of the annuity at the beginning of the year is $1,480,000 and the fair value at the end of the year is $1,440,000. Interest rates have not changed. Although the fair value has decreased by $40,000 over the year, Company A has received $100,000 in benefits. The net effect of the receipt of benefits and the change in the fair value is a gain of $60,000, which reflects both interest earnings and a slight increase in the expected age at death.

Example 2b illustrates an annuity's fair value loss that results from a spike in interest rates.

**Example 2b**

Company A (from Example 1) purchases a single premium, immediate annuity of $100,000 per year on an executive age 65 for a premium of $1,666,667. Five years later the fair value of the annuity at the beginning of the year is $1,480,000 and the fair value at the end of the year falls to $1,080,000, reflecting a 3% spike in interest rates. Although the fair value has decreased by $400,000 over the year, Company A has received $100,000 in benefits. The net effect of the receipt of benefits and the change in the fair value is a loss of $300,000, which primarily reflects an increase in interest rates.

Example 2c illustrates the complete loss of an annuity's fair value as a result of the death of the insured executive. Because annuity benefits stop at death(s) of the annuitant(s), the value of an annuity disappears at death. Any fair value on the date of death becomes a loss.

**Example 2c**

Company A (from Example 2) owns an annuity with a fair value of $1,440,000 when the insured executive dies. Because the annuity is a single life annuity with no refund feature or death benefit, the value of the annuity is zero. Company A derecognizes the value of the annuity and records a loss of $1,440,000.

The net effect of the end of year fair value and distributions received during the year compared with the beginning of year fair value is gain or loss that flows though net income.[20] Reporting gains and losses through other comprehensive income (OCI) is not available under the fair value option of Subtopic 825-10.[21]

**Accounting Disclosure**

Unlike many other financial instruments, insurance contracts do not require disclosures about fair value.[22]

***Accounting for SERPs***

Unlike annuities, SERPs are not recorded at fair value.[23] Instead, Subtopics 710-10 and 715-30 determine the amount of the liability. Like annuities, SERPs experience gains and losses attributable to changes in discount rates and mortality assumptions. Arrangements that are individual arrangements (that is, not part of a plan) follow the guidance of Subtopic 710-10.[24] Employers should accrue the present value of all future benefits by the full eligibility date,[25] and spread that expense in a "rational and systematic manner" over the attribution period.[26]

Subtopic 710-10 makes no provision for the delayed recognition of gains and losses,[27] which occur as a result of changes in assumptions or experience that differs from assumptions. All SERP expense for individual arrangements (including gains and losses) flows through net income.

SERP arrangements that are plans follow the guidance of Subtopic 715-30.[28] The liability is referred to as the projected benefit obligation (PBO),[29] which reflects the present value of future benefits attributable to past service. Future benefits include benefits contingent on future pay increases. Each year that the executive survives creates a loss to reflect an increasing expected age at death (and additional expected benefit payments). Death creates a gain to reverse the liability for the deceased executive. Gains and losses may be recognized immediately or through OCI.[30] Accumulated OCI (AOCI) for such gains and losses is a component of shareholder equity[31] and subject to a minimum amortization process when the gain or loss exceeds 10% of the PBO.[32] Most employers elect the delayed recognition of the OCI approach. When a plan is implemented or amended, the change in the PBO always flows through OCI, with a separate amortization schedule.[33] A more complete description of SERP accounting is beyond the scope of this article.

***Accounting for Buy-Ins: Coordinating Both Sides***

Although lower interest rates and longer life expectancies increase both the fair value of annuities and the calculation of the PBO, the purchase of annuities does not neutralize net income. Employers electing delayed recognition of SERP gains and losses must manage a change in accounting principle to avoid an accounting mismatch. Whereas gains and losses on annuities always flow through net income, employers have a choice in where gains and losses on SERPs flow. A previous election to delay SERP gains and losses conflicts with immediate recognition of annuity gains and losses. In this case, the employer might consider a change in accounting principle[34] in order to neutralize the effect on net income. Absent such a change in accounting principle, the annuity gains and losses will increase the volatility of net income. Of course, a change in accounting principle for SERPs could have broader implications, such as requiring immediate recognition of gains and losses for the employer's other pension plans.[35] This could potentially have an impact on the company's financial statements that is much more material than the accounting mismatch for the SERP.

**Example 3**

Company A (from Example 2) owns annuities with a fair value of $1,440,000 and owes a SERP liability of $1,440,000. A combination of higher interest rates and changes in the mortality assumption causes a $60,000 loss in the annuity and a $60,000 gain in the SERP. The tax rate is 40%. An accounting mismatch causes a $36,000 net loss. Had Company A elected a change in accounting principle, the effect on net income would have been zero.

| | Mismatch | Matched |
|---|---|---|
| SERP expense - gain (loss) | $0 | $60,000 |
| Other income (loss) from annuities | (60,000) | (60,000) |
| Tax expense (benefit) | (24,000) | - |
| Net income | ($36,000) | $0 |
| Gain (loss) net of tax from SERP | $36,000 | $0 |
| Other comprehensive income | $36,000 | $0 |
| Comprehensive income | $0 | $0 |

Unfortunately, a change in accounting principle from delayed recognition of benefit obligation gains and losses to immediate recognition requires navigating several obstacles, which include:

- Preferability letter from outside auditor (SEC registrants only)
- Retrospective application, resulting in income statement recognition of any historical gain or loss currently recognized in AOCI
- More frequent recognition of benefit gains and losses (prospectively)
- Immediate recognition of all pension gains and losses (not just gains and losses for SERPs hedged with annuities)
- Imperfect matching of annuity gains/losses with benefit obligation losses/gains

SEC registrants that want to change from delayed recognition of benefit losses and gains to immediate recognition must secure a letter from their outside auditors supporting the preferability of such a change in accounting principle.[36] Accelerating the recognition of losses and gains and avoiding accounting mismatches are both considered improvements in financial reporting.

Employers that elect such a change in accounting principle must apply the change retrospectively.[37] Any prior periods presented in the financial statements must reflect the change. The earliest balances shown should reflect the cumulative effect of applying the change to all prior periods with a corresponding adjustment to retained earnings.

Each prior period presented must reflect the period-specific effect of the change.

The result of retrospective application is that the full amount of any cumulative loss (or gain) in AOCI must be recognized in the income statement for the current period and prior periods. Most SERPs have losses rather than gains in AOCI as a result of declining discount rates and other factors. Consequently, switching from delayed recognition to immediate recognition usually requires the recognition of significant benefit expenses and reductions in net income in current and prior periods. The recognition of the deferred tax benefit (or expense) related to the loss (or gain) mitigates the effect of such expense on net income.

Although quarterly benefit valuations are not required, doing so avoids the timing differences that result from valuing the assets quarterly while valuing the benefit liability annually.

An accounting change to immediate recognition of gains and losses requires the immediate recognition of all gains and losses under all qualified and nonqualified pension plans,[38] not just gains and losses of obligations hedged by annuity contracts. If a significant portion of the benefit liability is not hedged with annuity contracts, immediate recognition can cause increased volatility in benefit expense. This can occur when a significant number of participants have not yet begun to receive benefit payments, which discourages the purchase of annuities for the reasons discussed in the Appendix.

Annuity gains and losses do not neutralize benefit obligation losses and gains precisely. Because the actuarial assumptions in calculating the benefit obligation will rarely match the fair value of annuities (as measured by the pricing of replacement contracts), the changes in those actuarial assumptions and the annuity pricing will result in different amounts. As a result, the combined effect on net income will not be zero.

When switching from delayed recognition to immediate recognition creates a cumulative adjustment that is not material, a lump sum adjustment to benefit expense is a possibility.[39] However, auditors may be reluctant to issue a preferability letter that supports immediate recognition of gains and losses for SERPs but delayed recognition for qualified plans. The effect of aggregating all pension plans, qualified and nonqualified, increases the likelihood that any cumulative adjustment will be material and will require retrospective application.

### *Tax Accounting*

Whereas the SERP creates a deductible temporary difference that creates a deferred tax asset, the annuity creates a taxable temporary difference[40] that creates a deferred tax liability. Both the deferred tax asset and deferred tax liability reverse at death simultaneously with the reversals of the asset and liability.

**Cost Considerations**

Insurance carriers accept significant risk in issuing annuity contracts. The primary risks are investment risk and mortality risk. Expected investment returns are an important part of the insurance carrier's ability to pay the benefits guaranteed by the annuity contract. The insurance carrier also bears the risk that executives insured under the contract will live longer than expected. Insurance companies understand these risks and price annuities to not only cover the expected claims but to ensure a reasonable profit.

Annuities come in many varieties. One distinction is deferred versus immediate payout. The Appendix discussion of the taxation of corporate owned deferred annuities explains why deferred annuities are not appropriate for corporations. Employers that implement a buy-in strategy should wait until executives retire (or shortly before) to buy only immediate annuities. Another distinction is variable versus fixed. Variable annuities reflect the investment performance of separate accounts and do not guarantee a consistent benefit from year to year. Fixed annuities guarantee a monthly benefit for the life of the insured executive. Because employers usually want to match annuity payouts with SERP benefit amounts, only fixed annuities are appropriate for buy-in strategies.

The premiums for immediate fixed annuities depend primarily on interest rates and the age of the insured. Low interest rates and young ages (long life expectancy) increase the single premium relative to the monthly benefit. Highly rated insurance carriers can charge higher premiums (that is, credit lower interest rates) that reflect their superior claims paying ability. With interest rates hovering near record lows and life expectancies creeping to ever higher ages, the current pricing for annuities approaches record highs. The sex of the insured can also affect premiums. Because females generally live longer than males, premiums for females are higher than premiums for males for the same monthly benefit. In the retail annuity market, death benefits, guaranteed minimum withdrawal rights, and commissions increase annuity premiums. In the institutional market, group underwriting affects pricing. For example, employers that plan to insure every participant currently receiving benefits from a SERP that does not offer a lump sum may receive more favorable pricing than an employer that allows participants to elect a lump sum. Participants who are in poor health often elect lump sums, and insurance carriers need the expected gains on these individuals to make pricing concessions based on group underwriting.

### SEC Compliance

Because buy-ins do not affect the executive, the Securities and Exchange Commission (SEC) requires no Proxy disclosure of compensation when an SEC registrant implements a buy-in strategy. However, changes in accounting principle require disclosure in the Management Discussion & Analysis section of the Proxy.[41] The auditors' preferability letter is an exhibit to the first Form 10-K or 10-Q that follows the change.[42]

### Pros of a Buy-In

A buy-in allows an employer to lock in future cash inflows that equal pre-tax cash outflows and offers a degree of benefit security when a rabbi trust owns the contract. Employers that navigate a change in accounting principle realize the additional benefit of significantly neutralizing the effect of gains and losses on net income. The liability is effectively immunized and the employer doesn't have to concern itself with a market loss of its investment.

### Cons of a Buy-In

A buy-in requires paying premiums on immediate annuities for participants who currently receive benefits. Current pricing for annuities makes such a purchase unattractive for many employers. Navigating a change in accounting principle and determining the fair value of the annuities each year creates soft costs without removing the liability from the books. Purchasing an annuity also creates single counterparty risk, albeit the likelihood of default on a large, diversified and highly regulated insurance company is low. For many employers, a buy-in is not compelling.

## BUY-OUTS

Unlike a buy-in, a buy-out does eliminate the liability, but it also accelerates the executive's taxes. A buy-out is the tax equivalent of paying taxable lump sums to executives in lieu of future SERP benefits, and then requiring (or allowing) the executives to buy annuities. The executive either owns the annuity or a secular trust owns the annuity on his behalf. The annuity premium paid by the employer is taxable to the executive[43] and generally deductible by the employer.[44] If the secular trust purchases the annuity, the executive and employer tax event occurs at the later of the time of purchase or the time the executive has a vested interest in the annuity.[45]

Buy-outs require employers to consider IRC § 409A, the effect of income tax withholding on lump sums, Proxy and 8-K reporting (for SEC registrants), settlement accounting, whether to make the purchase of annuities elective or nonelective, and other issues. Executives in pay status receive immediate annuities, whereas active executives and terminated vested executives receive deferred annuities or cash.

Unlike qualified plans, SERPs have no specific requirements on how lump sums are determined. Unless the SERP plan document specifies the lump sum factors (or assumptions) for termination of the plan, employers have some flexibility in determining the lump sums. Employers can choose to use the qualified plan rules for lump sums,[46] the plan assumption for limited cashouts,[47] market annuity rates, or specific discount rate and mortality assumptions. Employers must also make decisions on whether to accelerate vesting and the expected retirement date when determining lump sums.

**IRC § 409A**

Regardless of how a company determines the lump sum, avoiding tax penalties under IRC § 409A is paramount. These penalties include a 20% penalty tax and interest in addition to regular taxes.[48] Congress enacted IRC § 409A in 2004 to standardize the timing of deferred compensation deferral and payout elections in response to the Enron scandal. IRC § 409A complicates the buy-out process for any SERP arrangements that are subject to IRC § 409A. In general, SERP arrangements that do not reflect service after 2004 are exempt from IRC § 409A.[49] For example, executives who retired before 2005 and fully vested arrangements that do not reflect changes in compensation after 2004 are exempt from IRC § 409A. For arrangements exempt from IRC § 409A, the buy-out process can begin immediately. For arrangements subject to IRC § 409A, a buy-out is a multi-step process:

- Complete inventory of non-account balance plans subject to IRC § 409A within controlled group

- Irrevocable action[50] taken by employer to terminate and liquidate all nonaccount balance plans across controlled group (IRC § 409A prohibits such elections when "proximate to a financial downturn"[51])

- Liquidation must occur during the second 12 month period following the irrevocable action, while scheduled benefit payments under the plan continue[52]

- Payout of 100% of benefits for 100% of participants under all non-account balance plans (within the controlled group) subject to IRC § 409A[53]

- No new non-account balance plans allowed until the 37th month following the irrevocable election to terminate and liquidate all nonaccount balance plans subject to IRC § 409A[54]

**Payroll Tax Withholding**

An employer's payment of a premium for an annuity owned by the executive is taxable as wages[55] and subject to payroll tax withholding, which can include federal,[56] state, and local income taxes, and FICA. Form W-2 reports supplemental wages for active executives, terminated vested executives, and retirees. Employers withhold on active executives at 25% on the first $1 million of supplemental wages[57] and 39.6% on the excess.[58] Terminated vested and retired executives see withholding based on their W-4 on the first $1 million of supplemental wages and 39.6% on the excess.[59] Lump sums are subject to FICA tax unless previously included in FICA (e.g., retirees).[60] FICA includes 6.2% Social Security tax up to the wage base ($113,700 for 2013),[61] 1.45% Medicare tax,[62] and a 0.9% Medicare surtax on wages in excess of $200,000.[63] State income tax withholding for terminated, vested participants and retirees is often limited to the state of residence because federal source taxation rules restrict non-resident states from taxing certain retirement income of former residents.[64] However, active executives may have to suffer withholding from multiple states in which the benefit was earned, and a buy-out can disqualify even some retirees from the federal protections. Non-employees such as surviving spouses and ex-spouses receive form 1099-MISC[65] and require no withholding when the non-employee recipient provides a Social Security number.[66]

If the employer pays a premium for an annuity that provides the same pretax benefit as the SERP, the executive needs to pay the withholding from another source or the corporation has to gross-up the benefit.

**Example 4**

Company A (from Example 1) owes a recently retired 65 year old executive a SERP of $100,000 per year and purchases a single premium, immediate annuity of $100,000 per year for a premium of $1,666,667. Payroll includes the amount on the executive's W-2 as taxable wages and determines that required payroll tax withholding is $666,667. Company A either withholds that amount from other after-tax cash compensation otherwise payable to the executive, or requires the executive to write a check to the employer for that amount. Company A decides not to gross-up the arrangement. Doing so would cost the Company $1,111,111 in additional cash compensation to indemnify the executive for both the \$666,667 tax outlay and the additional taxes on the gross-up at a 40% tax rate.

The executive's after-tax income from the annuity is \$93,333. This represents the \$83,333 non-taxable portion of the \$100,000 annual benefit (see the exclusion ratio in Example 1b) plus the after-tax income of \$10,000 on the remaining \$16,667. Although the \$93,333 is significantly greater than the \$60,000 after-tax benefit from the SERP, even executives are not happy about paying taxes out of pocket.

A solution is to withhold taxes from a lump sum and purchase an annuity with the after-tax amount on a money purchase basis.

**Example 5**

Company A (from Example 4) decides to pay the same \$1,666,667 to settle its SERP obligation and includes the amount on the executive's W-2 as taxable wages. The payroll department determines that required payroll tax withholding is \$666,667 but withholds that amount from the total for payroll taxes. Company A uses the remaining \$1,000,000 to purchase a single premium, immediate annuity with an annual benefit of \$60,000. The executive is no longer out of pocket for payroll taxes.

Withholding the payroll taxes from the lump sum reduces both the premium and the benefit. Whereas the executive expected an annual SERP benefit of \$100,000, the annuity provides an annual benefit of \$60,000. However, the effect of the exclusion ratio reduces the after-tax difference between the two benefits as illustrated in Example 6.

Although withholding taxes from the lump and purchasing an annuity with the after-tax amount reduces both the annuity premium and the gross benefit, Example 6 shows that the after-tax benefit is surprisingly close to the after-tax SERP benefit for the first twenty years in today's low interest rate environment. Example 7 will describe what happens after those first twenty years.

**Example 6**

The executive in Example 5 has a life expectancy of 20 years as determined from the IRS tables. The expected benefit payments are \$1,200,000 (twenty years at \$60,000 per year). The exclusion ratio is 83.33% (\$1 million divided by \$1.2 million), and \$50,000 of each annual payment (\$60,000 times 83.33%) is a tax-free return of the investment in the contract. The remaining \$10,000 is taxable as ordinary income. Tax at 40% on the income is \$4,000, so the after-tax benefit is \$56,000 (until the 21st year).

The SERP would have provided an annual pre-tax benefit of \$100,000, which created taxes of \$40,000 (at a 40% tax rate). The after-tax benefit would have been \$60,000.

The after-tax annuity income is 93% of the after-tax SERP benefit, until the 21st year when the executive recovers his full $1 million investment in the contract. After the 20th year, the annuity payments of $60,000 per year are fully taxable (just as the future SERP payments would have been) and represent a 40% reduction in the after-tax income compared to the SERP from that point forward.

**Executive Perspective**

Executives suffer lower after-tax income even when annuity pricing determines the lump sum and the tax rate remains the same.

**Example 7**

The 65 year-old executive in Example 6 receives 7% less after-tax income under the annuity than under the SERP until age 85, but 40% less thereafter. After the executive recovers his tax basis in the annuity contract (at age 85 in this Example), the annuity benefits are fully taxable. An executive who has acclimated himself to the low taxation of the early benefits will flinch at the higher taxation and lower after-tax income in the later years.

Of course, tax rates often don't remain the same when executives receive a lump sum. Executives who benefit from graduated tax rates below the maximum rate incur higher rates on lump sums.

**Example 8**

The executive in Example 7 had expected his $100,000 annual SERP benefit to be part of his $250,000 annual taxable income. Progressive tax rates effective in 2013 cause the marginal taxes on the $100,000 to be a combination of 31% and 36%. Including the entire $1,666,667 in taxable income in a single year subjects most of the benefit to the 39.6% highest marginal tax rate.

Employers that want to indemnify executives for the immediate effect of lump sum taxation illustrated in Example 8 and the late in life reduction in after-tax income in Example 7 can increase the lump sum and incur additional expense.

**Buy-Outs for Active and Deferred Vested Participants**

Immediate annuities are not appropriate for active and deferred vested participants who do not expect to start receiving benefits until a future date that may depend on separation from service. Unfortunately, deferred annuities may guarantee interest rates for a period, but rarely guarantee life time benefits. Paying cash to buy out active and deferred vested participants may be the best option. Delaying the buy-out until a later date is not an option under IRC § 409A, which requires that all non-account balance arrangements subject to IRC § 409A be liquidated between the 13th and 24th months following an irrevocable election to pay lump sums.

**Accounting Considerations**

Accounting for buy-outs reflects settlement accounting, which eliminates the liability. The lump sums usually vary from the previously recorded liability for each executive. Where the lump sum exceeds the liability, the difference increases any loss (or decreases any gain) carried in AOCI net of tax. Where the liability exceeds the lump sum, the difference decreases any loss (or increases any gain) carried in AOCI net of tax. Settlement accounting requires the prorated recognition of any gain or loss included in AOCI.[67] Because SERPs often accumulate a loss in AOCI, settlement accounting often requires prorata recognition of that loss, even when lump sums are less than the liability. Example 9 illustrates the prorata recognition of AOCI net of tax when a company pays a lump sum that is less than the PBO. Eliminating the effect of future pay increases on SERP benefits, using a higher discount rate, and confirming the death of a potential surviving spouse of a retiree are all possible reasons for paying a lump sum that is less than the PBO.

**Example 9**

| Cash | DTA | Taxes Payable | PBO | AOCI Loss | AOCI Tax | Net Income |
|---|---|---|---|---|---|---|
| | $4,000,000 | | $10,000,000 | $2,000,000 | $800,000 | |
| | −80,000 | | −200,000 | −200,000 | −80,000 | |
| −5,880,000 | | −5,880,000 | | | | |
| | | | | −1,080,000 | | −1,080,000 |
| | | | | | −432,000 | 432,000 |
| | −2,352,000 | −2,352,000 | | | 0 | |
| −$5,880,000 | $1,568,000 | −$2,352,000 | $3,920,000 | $720,000 | $288,000 | −$648,000 |

Company D has a SERP with PBO of $10 million, a deferred tax asset (DTA) of $4 million, and an AOCI loss of $1,200,000, net of tax, when it decides to settle the $6,080,000 of the PBO that is grandfathered under IRC § 409A. In calculating the lump sums, Company D reduces the PBO for those executives by $200,000, which reduces the loss in AOCI. The reduction in the PBO reduces the DTA by 40% of the savings and reduces the tax benefit carried in AOCI. The lump sums paid total $5,880,000, which is 60% of the recalculated PBO. This forces 60% of the recalculated AOCI loss of $1,800,000 (or $1,080,000) to flow through net income as a benefit expense and forces 60% of the AOCI tax benefit of $720,000 (or $432,000) to flow through net income as a deferred tax benefit. Company D offsets a current tax benefit of $2,352,000 with a deferred tax expense of an equal amount, which equal 40% of the lump sum paid.

**Cost**

Because of the executives' cash flow issues driven by lump sum taxation discussed above, the cost of annuities does not necessarily determine the employer's cost. Instead, the employer's cost consists of some combination of payroll tax withholding, an annuity premium taxed as wages, and cash wages. Annuity pricing issues may or may not affect the employer's lump sum calculations for retired executives. Active and deferred vested executives often receive lump sums in cash because of the difficulty in guaranteeing future retirement income with a deferred annuity.

Like premiums for buy-in annuities, premiums for buy-out annuities are affected primarily by interest rates and mortality assumptions. Low interest rates increase premiums and vice versa. Younger executives are expected to receive more total payments on immediate annuities, and their premiums reflect this. Because insurance companies have to use conservative assumptions to guarantee the results of fixed annuities, premiums factors often exceed benefit liabilities for accounting purposes.

Unlike annuities for buy-ins, the payments made by the employer to (or on behalf of) a participant associated with a buy-out must reflect unisex mortality to comply with Title VII of the Civil Rights Act of 1964,[68] which prohibits discrimination based on sex in an employment context. With sex-distinct pricing, women would receive either less retirement income for the annuity premium paid by men, or women would receive a higher taxable lump sum to pay for an increased premium. Although annuities designed for the qualified plan market always use unisex pricing, nonqualified annuities do not always feature a unisex pricing option. Uniformly using either male or female rates, regardless of the actual sex of the insured, prevents discrimination based on sex. Because most executives are male, using all male rates may be an option.

In the retail annuity market, death benefits, guaranteed minimum withdrawal rights, and commissions increase annuity premiums. In the institutional market, pricing depends on the degree of adverse selection. Although executives who expect to live a long time may appreciate the purchase of an annuity on their behalf, executives who are in poor health may prefer to receive the lump sum entirely in cash. Because insurance carriers need the mortality gains on these premature deaths to pay for the extended benefits on those who outlive their life expectancies, allowing executives to opt out of an annuity purchase causes adverse selection. Annuities underwritten on a group basis often levy a surcharge on such elective arrangements to compensate for adverse selection.

### SEC Disclosure Requirement

The SEC requires disclosure of buy-outs for the named executive officers of SEC registrants. These disclosures can include proxy disclosure, Form 8-K, and exhibits of material contracts in Form 10-K or 10-Q. Proxy disclosure can include an explanation in the Compensation Discussion & Analysis and narrative disclosure in the accompanying pension table. Depending on the change in the benefit obligation, the Summary Compensation Table and Pension Table may be affected. For example, if the employer agrees in one reporting year to settle the obligation in 12 months and the cost of the settlement exceeds the current present value of the accumulated benefit obligation, there will be additional compensation reported in the pension column of the Summary Compensation Table and a higher present value number in the Pension Table.

### Summary of Buy-Out Pros and Cons

Buy-outs benefit employers primarily by allowing them to shed accounting liabilities and the future uncertainty of guaranteeing lifetime benefits. Executives benefit by no longer being general creditors of the employer.

Buy-outs cost employers by requiring significant cash outlays and causing immediate recognition of losses previously carried in AOCI. Executives often bristle at lump sum taxation and the challenges of duplicating the after-tax retirement income that the SERP would have provided. When the financial strength of the employer is high, executives may balk at substituting credit risk from the employer for credit risk from the insurance carrier.

A buy-out makes sense when benefit security is more important than cost or an employer is highly motivated to reduce benefit liabilities.

## SETTLEMENT WITH DEFERRED EXECUTIVE TAXATION

Although buy-ins and buy-outs are the traditional approaches to using annuities to cover a SERP obligation, a third option may exist for employers that insist on shedding liabilities: settlement with deferred taxation. In this case, the employer sheds the accounting liability for executives who are currently receiving benefits, without accelerating their taxes. Executives are then general creditors of both the employer and the insurance company.

Executives who complain about this additional risk are reminded that keeping the liability on the books is not an option. The alternative is lump sum taxation and the possibility of lower after-tax retirement income for all participants. Executives may prefer the status quo to the new arrangement, but probably prefer settlement with deferred taxation over lump sum taxation when they believe that both their employer and the insurance carrier represent low credit risks.

Arrangements subject to IRC § 409A must treat all participating executives the same way. Either all executives receive the taxable lump sum of the buy-out approach, or all executives receive benefits according to the terms of the plan. Plans that are grandfathered under IRC § 409A and require employee consent for any plan modifications may have to be unanimous in order to avoid constructive receipt of a lump sum option or loss of grandfathering under IRC § 409A.

After gaining the support of executives, tax counsel and outside auditors, the employer:

- Amends the SERP to define the benefit as the benefit payable by an annuity contract that is equal in amount to the promised benefit under the SERP

- Explicitly communicates to participants the SERP benefit is limited to payments under the annuity contract (the employer does not guarantee any shortfall)

- Pays a single premium for an immediate annuity on participants who are receiving benefits (or will begin receiving benefits within the next twelve months)

- Decides whether to commit to buying annuities on future retirees or whether to amend the plan for only current retirees (only immediate annuities are purchased and only on retirees)

The insurance carrier:

- Withholds from each annuity payment federal income taxes for retirees based on each executive's W-4, and withholds state income taxes as appropriate, although the corporation remains legally responsible for the withholding

- Pays the net benefit directly to executive or surviving spouse

Not all insurance carriers are willing or able to withhold payroll taxes on the employer's behalf based on the executive's form W-4. Local taxes can also complicate the process. The insurance carrier does not withhold FICA taxes, because the employer includes the present value of the benefit in FICA income before benefits start. Federal law[69] on source taxation should limit state taxation to the state residence (rather than multiple potential states in which the benefit was earned).

A rabbi trust:

- Owns the annuities to ensure that the executives (or surviving spouses) remain as beneficiaries under the contracts unless and until the employer declares bankruptcy
- Follows the direction of the bankruptcy judge if and when the employer declares bankruptcy

**Tax Considerations**

The executive pays taxes just as he would have under the original SERP because he remains a general creditor of his employer and the timing and form of payment have not changed. Receiving the benefit from the insurance carrier instead of the employer has no substance for tax purposes.

The employer's tax situation is identical to the buy-in. The employer only purchases immediate annuities exclusively for participants who currently receive benefits or who will begin to receive benefits within the next twelve months. IRC § 72(u) (discussed further in the Appendix) discourages corporate ownership of deferred annuities. Benefit payments are deductible as the executive receives the benefits from the insurance carrier and includes them in taxable income. The employer's rabbi trust is the owner of the policy. Because a rabbi trust is a grantor trust, the employer (as grantor) is treated as the owner of the annuity. As explained in the earlier section on buy-ins, the deductions for the benefits exceed the taxable income from the annuity until the tax basis of the annuity is fully recovered.

**Accounting Considerations**

This transaction meets all three criteria for settlement accounting:[70]

1. It is an irrevocable action.
2. It relieves the employer of primary responsibility for a pension obligation.
3. It eliminates significant risks related to the obligation.

**Irrevocable Action**

Purchase of a single premium immediate annuity is irrevocable. Immediate annuities have no cash surrender value. The rabbi trust prevents the employer from assigning the benefits or naming itself as the beneficiary. Although benefits under the annuity contract could revert to other general creditor if and when the employer declares bankruptcy, accounting rules assume that the employer is a going concern.[71] As a going concern, nothing will disrupt the flow of any annuity benefits to the executive except the insolvency of the insurance carrier.

Amending the plan to define the benefit as the monthly benefit provided by the annuity contract distinguishes settlement with deferred taxation from a buy-in. Because a buy-in allows the employer to pay benefits directly (and forces the rabbi trust to redirect benefits in order to avoid duplication of the benefit), a buy-in is not irrevocable. Settlement with deferred taxation is irrevocable because the amended plan allows only the insurance carrier to pay the benefit, which is limited to the amount provided under the annuity contract.

**Employer Relieved of Primary Responsibility for SERP Obligation**

The insurance carrier has primary responsibility for the SERP obligation. The insurance carrier withholds payroll taxes and pays the executive directly. The employer never pays a benefit promised by the annuity contract. If the insurance carrier defaults, the executive loses the benefit. The employer's contingent liability for the carrier's underwithholding of payroll taxes does not cause the employer to have primary responsibility for the SERP obligation.

Settlement with deferred taxation differs from a buy-in because the employer maintains primary responsibility for the SERP obligation in a buy-in, even when the insurance carrier acts as the employer's agent for paying the benefit. Settlement with deferred taxation defines the insurance carrier as the sole source of the benefit payments, which could end upon the insolvency of either the employer or the insurance carrier.

**Elimination of Significant Risk**

Immediate annuities eliminate the employer's risk that investments will underperform expectations and that executives will outlive actuarial assumptions for their life expectancy. These are the employer's primary risks in a defined benefit SERP.

Under settlement accounting, the employer eliminates the liability for transactions that meet the three criteria above and recognizes a prorata portion of the gain or loss carried in accumulated OCI, including the gain or loss first measured as a result of the settlement.

The percentage of the gain or loss recognized equals the percentage reduction in the projected benefit obligation.

The result is similar to the result in Example 10, but there is no current tax benefit. Because executives avoid the lump sum taxation and pay taxes only as they receive the benefits, the employer defers its tax deductions until the executives recognize the income.[72] For tax accounting purposes, there is neither immediate realization of the deferred tax assets nor additional accruals of deferred tax benefits on settled obligations. Instead, the existing deferred tax asset is realized as appropriate.

**Example 11**

| Cash | DTA | Taxes Payable | PBO | AOCI Loss | AOCI Tax | Net Income |
|---|---|---|---|---|---|---|
| | $4,000,000 | | $10,000,000 | $2,000,000 | $800,000 | |
| | 120,000 | 300,000 | 300,000 | 120,000 | | |
| –7,000,000 | | | –7,000,000 | | | |
| | | | | –1,563,107 | | –1,563,107 |
| | | | | | –625,243 | 625,243 |
| –$7,000,000 | $4,120,000 | | $3,300,000 | $736,893 | $294,757 | –$937,864 |

Company E has a SERP with a PBO of $10 million, a deferred tax asset (DTA) of $4 million, and an AOCI loss of $1,200,000, net of tax, when it decides to settle the $6,700,000 of the PBO that is owed to current retirees. After accepting an annuity offer, Company E increases the PBO for those executives by $300,000, which increases the loss in AOCI. The increase in the PBO increases the DTA by 40% of the increased obligation and increases the tax benefit carried in AOCI. The lump sums paid totals $7,000,000, which is 68% of the recalculated PBO. This forces 68% of the recalculated AOCI loss of $2,300,000 (or $1,563,107) to flow through net income as a benefit expense and forces 68% of the AOCI tax benefit of $920,000 (or $625,243) to flow through net income as a deferred tax benefit. The deferred tax asset of $4,120,000 remains unrealized and now exceeds the remaining liability.

**SEC Disclosure Requirement**

Executives experience no substantive change in their benefit, but the lack of a liability for accounting purposes should not eliminate the need for ongoing disclosure in the Summary Compensation Table (Proxy), Pension Table (Proxy), and exhibit of material contracts (10-K and 10-Q). Narrative comments may be required to supplement the Summary Compensation Table, Pension Table, and Compensation

Discussion and Analysis to explain why the financial statements do not reflect SERP benefits.

**Summary of Pros and Cons**

Settlement with deferred taxation allows companies to eliminate benefit liabilities for SERP participants who currently receive benefits, and allows executives to continue to defer taxes until receipt of the benefit.

However, settlement with deferred taxation requires significant annuity premiums for SERP participants who currently receive benefits. Auditors and tax advisors may resist an unfamiliar plan design. Executives who were general creditors of their employer under the SERP now face the additional risk that the insurance carrier defaults.

**Push Back**

Employers that explore the settlement with deferred taxation plan design should prepare for skepticism from auditors, who find comfort in the more tried and true plan designs. Criticism of the settlement accounting result includes the inconsistency between the tax and accounting results.

**How can the employer own the annuity for tax purposes but not accounting purposes?**

Tax rules and accounting rules have different purposes, and numerous examples exist where beneficial ownership differs for tax and accounting purposes.

**How can the annuities be available to general creditors in bankruptcy but not recorded as assets?**

U.S. GAAP treats companies as going concerns. The annuity payments are not available to creditors unless the employer is no longer a going concern.

**How have other companies recorded similar transactions?**

No information is available on how employers have recorded this arrangement for accounting purposes, or whether such an arrangement has ever existed.

## SUMMARY

Employers that want to consider using annuities to either finance or settle SERP liabilities should consider only immediate annuities because of the unfavorable tax treatment of corporate-owned deferred annuities. After considering the tax and accounting issues, employers should evaluate both buy-ins and buy-outs. More adventurous employers might explore settlement with deferred taxation with their tax counsel and outside auditors.

## APPENDIX

### Unfavorable Taxation of Corporate-Owned Deferred Annuities

In 1986 Congress added § 72(u) to the Internal Revenue Code (IRC) to discourage corporations from buying deferred annuities for their tax advantages.[73] Deferred annuities pay the beneficiary periodic benefits that start more than twelve months after the annuity is purchased.[74] Congress was concerned that companies would finance nonqualified plans at the expense of qualified plans, thereby creating more security for executives and less security for other employees. To discourage such behavior, IRC § 72(u) states that a corporate-owned deferred annuity "shall not be treated as an annuity contract."[75] IRC § 72(u) taxes corporate-owned deferred annuities to the point where the after-tax results are unattractive to any tax paying corporation that understands the tax results. Corporate- owned deferred annuities cause all distributions and policy values to be included in taxable income.

Whereas immediate annuities usually feature no cash value, Congress presumed that net surrender values would exist after a corporation started receiving distributions from a deferred annuity. Evidence of this presumption is the description of "income on the contract":[76]

> the sum of the net surrender value of the contract as of the close of the taxable year plus all distributions under the contract received during the taxable year or any prior taxable year

To prevent taxing amounts previously taxed, Congress reduced the gross amount of the income by both the premiums and amounts previously taxed.[77]

### Appendix Example 1

Company B purchased a deferred annuity eleven years ago for a premium of $1 million. Low interest rates and product charges caused the net surrender value to remain below the premium in past years. This year, Corporation B received the first of the $100,000 annual payments payable under the contract. The net surrender value is $934,000. According to the formula above, gross income on the contract equals $1,034,000, which is the cumulative distributions, plus the net surrender value. Because the premium was $1,000,000 and no amounts have been previously taxed, the net income on the contract is $34,000. Next year, the income on the contract will reflect that $34,000 of previously taxed income in order to prevent double taxation.

**Fair Value to Prevent Tax Avoidance**

Because Congress feared that corporations would favor deferred annuities that would understate net surrender value to avoid taxation, IRC § 72(u) includes a provision in which the Secretary (of the Treasury) can substitute fair value for net surrender value to prevent avoidance of taxation.[78] Because deferred annuities lose most or all of their net surrender value soon after distributions start, the IRS has a strong incentive to substitute fair value for net surrender value.

Although IRC § 72(u) never defines fair value in the context of annuities, the courts have given considerable thought to the concept of fair value for tax purposes in other contexts.[79] Fair value is the price negotiated between "a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts."[80] Net surrender value is not a measure of fair value because it is contractual. The annuity contract requires the insurance carrier to pay the net surrender value upon the request of the policy owner. Fair value implies a secondary market for annuity contracts in which willing buyers and sellers negotiate prices, similar to the life settlement market for life insurance contracts.

However, no such market for annuity contracts exists. If such a secondary market did exist, buyers would be understandably concerned that the employer might be selling only annuities on insured executives who were expected to die prematurely. Whereas the expectation of premature death increases the value of a life insurance policy, the expectation of premature death reduces the value of an annuity. A premium quote for a new annuity would not necessarily establish fair value because while an insurance carrier would welcome annuity applications from executives in poor health, a buyer would not pay the quoted premium with that knowledge. Instead, a premium quote for a comparable annuity from a comparable insurance carrier establishes the maximum that a willing buyer would pay for an annuity.

A practical approach to estimating fair value is to have a retirement actuary provide lump sum factors that reflect current interest rates and mortality assumptions. The resulting values should not exceed the cost of buying a new contract and should reflect period to period changes in interest rates and mortality assumptions. For example, when interest rates rise, the value of the annuities should fall. Also, the value of the annuity increases with each year of survival. An insured executive who is age 65 might be expected to live to 87, but by the time that the executive reaches age 87 his life expectancy has increased. The value of those expected additional annuity benefits is recognized gradually each year. When the insured executive dies (or both spouses have died in the case of joint and last survivor annuity), the value of the annuity drops immediately to zero.

The IRS' ability to substitute fair value for net surrender value dramatically increases the potential tax expense as a result of including those values in taxable income. Without the provision for taxing corporations on the fair value of deferred annuities, insurance carriers could suppress net surrender value during the accumulation period before retirement and then eliminate the surrender value entirely once payouts start. The result would be little or no taxable gain during the accumulation period and taxable income only to the extent that payouts actually received exceed the cost basis, which comprises the premiums paid plus previously recognized income if any. This approach would create little disincentive for corporations to buy deferred annuities.

Including the fair value of the deferred annuity in "income on the contract" causes the corporation to pay tax on income it will never realize. At death, the corporation will have paid tax on the cumulative distributions, plus the fair value less the premium. Because the distributions stop at the death of the insured (or insureds), the corporation will never realize that fair value included in income on the contract. Creative advisors might recommend a tax-free exchange of the deferred annuity to an immediate annuity in order to avoid this result, but a corporate-owned deferred annuity does not qualify for a tax-free exchange under IRC § 1035.[81] IRC § 72(u) does not treat corporate owned deferred annuities as annuities, and only annuities qualify for tax-free exchanges to annuities.

The practical result of paying tax on both cumulative distributions and fair value is that the corporate owner of the deferred annuity recognizes more taxable income than the actual gain in the contract when the annuity payments cease at the death of the insured (or insureds).

**Appendix Example 2**

| Age | A Annuity Cash Flow | B Surrender Value | C Fair Value | D Tax Value | E Taxable Income | F Cumul Taxable Income | G Annual Tax at 40% | H After-Tax Cash Flow |
|---|---|---|---|---|---|---|---|---|
| 54 | −1,000,000 | 919,100 | 1,000,000 | 1,000,000 | 0 | 0 | 0 | −1,000,000 |
| 55 | 0 | 924,615 | 912,191 | 924,615 | 0 | 0 | 0 | 0 |

| Age | A Annuity Cash Flow | B Surrender Value | C Fair Value | D Tax Value | E Taxable Income | F Cumul Taxable Income | G Annual Tax at 40% | H After-Tax Cash Flow |
|---|---|---|---|---|---|---|---|---|
| 56 | 0 | 939,723 | 995,519 | 995,519 | 0 | 0 | 0 | 0 |
| 57 | 0 | 954,296 | 1,078,750 | 1,078,750 | 78,750 | 78,750 | −31,500 | −31,500 |
| 58 | 0 | 968,302 | 1,161,569 | 1,161,569 | 82,819 | 161,569 | −33,128 | −33,128 |
| *64 | 0 | 1,038,661 | 1,640,601 | 1,640,601 | 76,434 | 640,601 | −30,574 | −30,574 |
| 65 | 102,768 | 934,657 | 1,630,461 | 1,630,461 | 92,628 | 733,229 | −37,051 | 65,717 |
| 66 | 102,768 | 828,320 | 1,593,528 | 1,593,528 | 65,835 | 799,064 | −26,334 | 76,434 |
| *70 | 102,768 | 378,938 | 1,404,234 | 1,404,234 | 54,038 | 1,020,842 | −21,615 | 81,153 |
| *75 | 102,768 | 0 | 1,136,252 | 1,136,252 | 56,701 | 1,266,700 | −22,680 | 80,088 |
| *80 | 102,768 | 0 | 905,793 | 905,793 | 33,960 | 1,550,081 | −13,584 | 89,184 |
| *85 | 102,768 | 0 | 769,975 | 769,975 | 91,099 | 1,928,103 | −36,440 | 66,328 |
| 86 | 0 | 0 | 0 | 0 | −769,975 | 1,158,128 | 307,990 | 307,990 |
| Sum | 1,158,128 | | | | | | | 694,877 |
| IRR | 3.86% | | | | | | | 1.39% |

*** Deleted rows**

1. **Single premium of $1 million and 21 payments of $102,768**
2. **Surrender value according to annuity contract**
3. **Estimate of amount a third party would pay for the annuity contract**
4. **Higher of B or C**
5. **Taxable income under IRC § 72(u) equals cumulative payments (receipts in column A) plus tax value (column D) less premium (outlay in column A) less amounts previously taxed (column of previous year)**
6. **Accumulation of E**
7. **=40% times E**
8. **=A+G**

Corporation B purchased a deferred annuity for a premium of $1,000,000 and received benefits of $102,768 per year for twenty-one years before the insured executive died. Just before the executive's death, the fair value of the annuity was $769,975. The cumulative gross income on the contract is $2,928,103 which represents twenty-one years at $102,768 per year plus the $769,975 fair value. The cumulative net income on the contract (i.e., taxable income) is $1,928,103, which reflects that gross income less the $1,000,000 premium. The actual gain on the contract was only $1,158,128, which is the $102,768 per year for twenty-one years, less the $1,000,000 premium. The cumulative net income of $1,928,103 exceeds the $1,158,128 actual gain on the contract by $769,975. Not coincidentally, this is the fair value of the contract at the time of death. The corporation included the fair value before death in net income on the contract, but will never realize that income.

### Deduction at Death to "True-Up" Taxable Income

General tax principles suggest that the owner of the annuity receives a tax deduction at death to "true-up" cumulative net income on the contract with the actual gain in the contract. For annuities not subject to IRC § 72(u), the annuity taxation rules do explicitly allow a deduction for the unrecovered investment in the contract.[82] Although the deduction at death for a corporate owned deferred annuity is not explicit in the Code, such a deduction seems reasonable.

### No 10% Penalty Tax

IRC § 72(u) does have a silver lining: no 10% penalty tax. IRC § 72(q) imposes a 10% penalty tax on amounts included in taxable income unless the income meets one of several exceptions, which include the taxpayer's reaching age 59 1/2 or income that is part of a series of substantially equal periodic payments over the life of the insured (or insureds). Corporations never reach age 59 1/2. However, the 10% penalty tax does not apply, because corporate-owned annuities are not treated as annuities. This result makes practical sense if much of that income has to be reversed to reflect the fair value of the contract at death (included in taxable income but never realized).

### Trust-Owned Annuities

IRC § 72(u)(1)(B) exempts annuities owned by trusts (or other entities) acting as agents for natural persons, but rabbi trust owned annuities do not meet this exemption. A rabbi trust is a trust intended to provide benefit security for executives who participate in nonqualified plans. The trust ensures that all trust assets are used to pay benefits unless the corporation declares bankruptcy. Because a rabbi trust is a grantor trust, the corporation is treated as the owner of all trust assets for tax purposes. The rabbi trust is not acting as agent for executives participating in nonqualified plans because the executives have no legal right to those assets until the trust distributes those assets and the executive recognizes taxable income.

Numerous private letter rulings (PLRs) have concluded that certain trust-owned deferred annuities are owned by trusts acting as agents for natural persons, that the natural persons are the beneficial owners (rather than legal or nominal owners) of the annuities, and that IRC § 72(u) does not apply.[83] However, none of these PLRs addressed rabbi trust-owned deferred annuities. Exempting rabbi trust owned deferred annuities from the scope of IRC § 72(u) conflicts with the legislative intent of IRC § 72(u).

**Effect of IRC § 72(u) on After-Tax Cash Flow**

Appendix Example 3 shows the effect of IRC § 72(u) on after-tax cash flow and assumes that income on the contract reflects the higher of net surrender value and fair value.

**Appendix Example 3**

Appendix Example 2 reflects a 3.86% internal rate of return (IRR) on the pre-tax cash flow of column A. Taxable income reflects cumulative benefits received in cash, plus the value of the contract, less the premium, less amounts previously taxed. The deduction at death equals the fair value of the contract just before death and adjusts the net taxable income to the actual gain. Even though the deduction causes the cumulative net income on the contract to equal the actual gain, the inclusion of the fair value in net income on the contract temporarily inflates taxable income. The 1.39% IRR on after-tax cash flow reflects that temporary inflation of taxable income.

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## NOTES

1. *See* Aon Hewitt, "Pension Settlement Trend Accelerates with Verizon Annuity Purchase," October 2012.
2. A rabbi trust is an irrevocable grantor trust established by the employer to protect executives from losing their benefits as a result of future management's refusal to pay the benefits due under the plan. A rabbi trust does not protect executives against the risk of the employer's bankruptcy. For a more complete discussion, *see* Bruce McNeil, *The Life and (Good) Times of a Grantor Trust – Part 1*, Journal of Deferred Compensation, Volume 18, Number 2 (Winter 2013).
3. IRC § 72(u).
4. IRC § 404(a)(1).
5. IRC § 404(a)(5).

6. Treas. Reg. § 31.3402(g)-1.
7. IRC § 264(a)(1).
8. IRC § 72(c)(1).
9. IRC § 72(b).
10. Treas. Reg. § 1.72-9 Table V.
11. Treas. Reg. § 1.72-4(a)(2) implies that the exclusion ratio be rounded to the nearest tenth of a percent (e.g. 83.3% instead of 83.33%). The examples in this article are only conceptual.
12. IRC § 72(b)(2).
13. IRC § 72(b)(3).
14. IRC § 72(b)(3)(C).
15. For a more complete discussion of reporting and withholding for nonqualified benefits, *see* Gregory J. Carrick and Lee Nunn, *Withholding and Reporting for Nonqualified Deferred Compensation and Executive Life*, Journal of Deferred Compensation, Volume 16, Number 2 (Winter 2011).
16. See for example the reference to an annuity contract in the definition of cash surrender value in Section 325-30-20.
17. Paragraph 325-30-35-1.
18. See definition of fair value in Section 825-10-20.
19. Paragraphs 820-10-55-3D and 55-3E.
20. Paragraph 825-10-35-4.
21. Annuity contracts do not fall within the scope of Topic 320, Investments – Debt and Equity Securities. See the discussion of the instruments that fall within the scope of Topic 320 in Paragraphs 320-10-15-5 through 15-7. Unrealized gains and losses for certain investments that do fall within the scope of Topic 320 flow through other comprehensive income.
22. Paragraph 825-10-50-8c.
23. Paragraph 825-10-15-5c.
24. For a more complete discussion of the distinction between individual SERP arrangements and SERP plans, *see* Lee Nunn and Dave Sugar, *Defined Contribution SERPs*, Journal of Deferred Compensation, Volume 16, Number 3 (Spring 2011).
25. Paragraph 710-10-30-1.
26. Paragraph 710-10-25-9.
27. Paragraph 710-10-45-2.
28. Paragraph 710-10-15-5c.
29. Paragraph 715-30-35-1A.
30. Paragraphs 715-30-35-18 through 35-28.
31. Paragraph 220-10-45-14.
32. Paragraph 715-30-35-24.
33. Paragraph 715-30-35-11.
34. Paragraphs 250-10-45-1 through 45-16.
35. *See* PwC Dataline No. 2011-03, Pension and OPEB accounting, Exploring changes in accounting policies, paragraph .32.
36. Rule 10-01(b)(6) of Regulation S-X.

37. Paragraph 250-10-45-5.
38. *See* PwC Dataline No. 2011-03, Pension and OPEB accounting, Exploring changes in accounting policies, paragraph .32
39. Paragraph 250-10-S99-3, SAB Topic 5.F, Accounting Changes Not Retroactively Applied Due to Immateriality.
40. Paragraph 740-10-25-20.
41. SEC Release Nos. 33-8350; 34-48960; FR-72 specifically refer to the need to discuss the effect of critical accounting estimates in the Management Discussion & Analysis. Although there is no explicit requirement to disclosure material effects of changes in accounting principle, such disclosure is consistent with the purpose of MD&A, which is to provide readers information "necessary to an understanding of a company's financial condition, changes in financial condition and results of operations."
42. Paragraph 250-10-S99-4, SAB Topic 6.G. 2.b, Reporting Requirements for Accounting Changes.
43. IRC § 83(a).
44. IRC § 83(h).
45. IRC § 402(b), which cross-references IRC § 83.
46. IRC § 417(e)(3).
47. Treas. Reg. § 1.409A-3(j)(4)(v).
48. IRC § 409A(a)(1)(B).
49. Treas. Reg. § 1.409A-6(a)(3)(i).
50. Treas. Reg. § 1.409A-3(j)(4)(ix)(C)(2).
51. Treas. Reg. § 1.409A-3(j)(4)(ix)(C)(1).
52. Treas. Reg. §§ 1.409A-3(j)(4)(ix)(C)(3) and (C)(4).
53. Treas. Reg. § 1.409A-3(j)(4)(ix)(C)(2).
54. Treas. Reg. § 1.409A-3(j)(4)(ix)(C)(5).
55. IRC § 83(a).
56. Treas. Reg. § 31.3402(g)-1.
57. Treas. Reg. § 31.3402(g)-1(a)(7).
58. Treas. Reg. § 31.3402(g)-1(a)(2).
59. Treas. Reg. § 31.3402(g)-1(a)(7)(i)(C), note the use of the term "regular" wages.
60. Treas. Reg. § 31.3121(v)(2)-1.
61. IRC § 3101(a).
62. IRC § 3101(b)(1).
63. IRC § 3101(b)(2).
64. 4 U.S.C.S. §114, Pension Source Act.
65. See the IRS instructions for Form W-2 or Form 1099-MISC.
66. See the IRS instructions for backup withholding in the instructions for Form 1099-MISC or part N in the General Instructions for Certain Information Returns.
67. Paragraph 715-30-35-79.
68. Codified as subchapter VI of chapter 21 of title 42 the United States Code. See Arizona Governing Committee for Tax Deferred Annuity and Deferred Compensation Plans v. Norris, 103 S. Ct. 3492 (1983).

69. U.S.C.S. §114, Pension Source Act.
70. See definition of Settlement in Section 715-30-20.
71. AICPA Statement of Auditing Standards AU § 341, The Auditor's Consideration of an Entity's
    Ability to Continue as a Going Concern.
72. IRC § 404(a)(5).
73. Joint Committee on Taxation's General Explanation of the Tax Reform Act of 1986, Deferred annuity contracts, Reasons for Change, p. 658.
74. As distinguished from an immediate annuity, which is defined in IRC § 72(u)(4).
75. IRC § 72(u)(1)(A).
76. IRC § 72(u)(2)(A)(i).
77. IRC § 72(u)(2)(A)(ii).
78. *Id*.
79. For example, Schwab v. Commissioner, 111 AFTR 2d 2013-1746 (Ninth Cir. April 24, 2013); Schwab v. Commissioner, 136 T.C. No. 6, (February 7, 2011); Rev. Proc. 2005-25, 2005-17 I.R.B. 962.
80. *Id*.
81. IRC § 1035(a)(3).
82. IRC § 72(b)(3).
83. Let. Rul. 9204014, 199905015, 9752035,9639057, 200449011.