



WRMarketplace

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The *WRMarketplace* is created exclusively for AALU Members by the AALU staff and Greenberg Traurig, one of the nation's leading tax and wealth management law firms. The *WRMarketplace* provides deep insight into trends and events impacting the use of life insurance products, including key take-aways, for AALU members, clients and advisors.

TOPIC: Annuities Can Be Taxing – 12 Things You Should Know.

MARKET TREND: As individuals look for investments that can manage both their overall income tax exposure and their desire for retirement income, interest in nonqualified annuities has increased.

SYNOPSIS: With higher tax rates and increasing life expectancies, individual investors face two major concerns: income tax exposure and outliving their income. Nonqualified annuities can help address both issues, since they can provide a source of lifetime income while deferring income tax on the investment growth within the annuity contract. The applicable income tax rules, however, are numerous and complex, including contract ownership requirements, the potential taxation of, and penalties for, early withdrawals, and possible income tax consequences upon the death of a contract holder or a gift of the contract.

TAKE AWAY: Knowledge and active management of nonqualified annuities can extend their potential tax deferral and mitigate the income tax obligations associated with these contracts. This places a premium on insurance advisors who have familiarity with the income tax issues and can work with experienced tax advisors to help ensure proper management of the potential tax exposure.

MAJOR REFERENCES: [*Internal Revenue Code \(“Code”\) §72.*](#)

As individual investors face rising tax rates and increasing life expectancies, nonqualified annuities¹ can address two major concerns: income tax exposure and providing retirement income. Annuities can offer a source of lifetime income while deferring income tax on the investment growth within the contract. The applicable income tax rules, however, are complex and can impact decisions regarding the annuity investment. The following summarizes just a few of the important tax aspects associated with nonqualified annuities.

BASIC ANNUITY CONCEPTS

Familiarity with some typical features of annuities can assist in understanding the taxation of these contracts, including options for the timing of premium payments, the timing of the start of annuity payments, determining the annuity amounts, and the annuity term.

Premiums - Single vs. Multiple. Single premium contracts are purchased for a single lump sum of cash. Fixed or flexible premium contracts are acquired for a series of cash premiums.

Annuity Starting Date - Immediate vs. Deferred. Immediate annuities are purchased with a single premium and provide for a series of substantially equal periodic payments (paid at least annually) beginning within one year of purchase. Annuity payments under deferred annuities start more than a year from issuance.

Annuity Payments - Fixed, Fixed Index and Variable

Fixed. Fixed annuities accrue interest at a rate guaranteed by the issuer over the deferral period and provide for fixed annuity payments after any deferral period.

Fixed Index. Fixed or equity indexed annuities generally are deferred annuities where the accrual of investment return under the contract is tied to the performance of a specified equity index (e.g., S&P 500).

Variable. With variable annuities, the annuity payments can vary or be fixed. The accrual of value, however, generally depends upon the investment performance of assets invested through a separate account.²

Annuity Terms/Payouts. Annuities can be single life, joint life (payments stop at the first death) or joint and survivor (payments continue until second death) and can include various payment terms:

Annuity for Life. The annuity payout is made from the annuity starting date until the annuitant dies. These annuities typically offer higher annuity payments, but the owner bears all the risk of a premature death.

Annuity for Life with Refund Feature. After the annuity starting date, the contract issuer must pay a specified minimum amount or make payments for a set period, regardless of when the annuitant dies. If the annuitant predeceases, the amounts are paid to the estate or the beneficiary designated under the contract by the contract holder.³

Term Annuity. These annuities make annuity payments for a fixed term of years or until the earlier of the end of a term of years and the annuitant's death.

INCOME TAXATION – 12 THINGS TO KNOW

- 1. The Rules – Code §72.** Code §72 and the underlying Treasury Regulations generally govern the taxation of amounts received under annuity contracts.
- 2. The Key - Tax Deferral.** The key feature of annuity taxation is income tax deferral – amounts earned within the contract generally are not taxed until paid or deemed paid.

Planning Point: Extending the deferral period, such as by delaying the start of annuity payments, or, as discussed in Number 11 below, naming a surviving spouse or a young beneficiary as the designated beneficiary of any remaining annuity contract benefits after the contract holder's death, can maximize this benefit.

- 3. The Annuity Payments – Ratable Recognition of Income.**⁴ Each annuity payment is treated partially as: (1) a tax-free return of investment in the contract (*i.e.*, total consideration

paid for the contract less prior amounts received and excluded from gross income) and (2) taxable income from the contract, based on an “exclusion ratio” determined under Code §72.⁵ The ratio represents the total investment in the contract as of the annuity starting date divided by the total expected return under the contract as of such date.⁶

Example. Jack is the owner and sole annuitant of an annuity that will make a \$15,000 annual annuity payment to Jack for his life. Assume Jack’s life expectancy (as determined under applicable Treasury Regulations) is 23 years.⁷ The expected return would be \$345,000 ($\$15,000 \times 23$). If Jack paid \$175,000 for the contract, the exclusion ratio is 50.7% ($\$175,000/\$345,000$), meaning \$7,605 of the \$15,000 payment is excluded from income ($\$15,000 \times 50.7\%$).

If an annuity based on one or more lives includes a refund feature, the investment in the contract will be reduced by the actuarial value of that feature (as determined under the applicable Treasury Regulations) when determining the exclusion ratio.⁸ For example, using the facts above, if Jack’s annuity provides for a 10-year guaranteed term that has an actuarial value of \$20,000, his investment in the contract would be reduced to \$155,000.

The determination of the exclusion ratio for variable contracts differs from the above, since the expected return may vary and cannot be precisely determined as of the annuity starting date. Thus, the amount of the annuity payment excludable from gross income is generally determined by dividing the investment in the contract (as adjusted for any refund feature), by the number of periodic payments anticipated during the annuity term.⁹ Again, using the original facts of the example above, if Jack’s annuity is a variable contract, his investment in the contract is \$175,000, and 23 periodic payments are expected, the amount excludable from the annuity payment is \$7,609 ($\$175,000 / 23$).

After recovery of the full investment in the contract, the entire annuity payment is includible in gross income.¹⁰ If, however, the annuitant dies before a recovery of the full investment in the contract, an income tax deduction is available for the unrecovered amount.¹¹ If the contract included a refund feature that factored into determination of the exclusion ratio, the amounts paid in satisfaction of the refund that are attributable to the investment in the contract are received, tax-free, until the investment is recovered.¹²

4. Amounts Not Received as Annuities – Potential for Tax on Full Amount. “Amounts not received as an annuity,” such as withdrawals or loans, may be fully taxable upon distribution, depending on both the timing and circumstances of the payment.

- *After Annuity Starting Date.* Non-annuity amounts received after the annuity starting date are includible in gross income.¹³
- *Before Annuity Starting Date.* Non-annuity amounts received before the annuity starting date are generally taxed based on the “last in, first out” (**LIFO**) rule – in other words, these amounts will carry out taxable income in the contract before they return basis.¹⁴
 - Withdrawals/Partial Surrenders. Withdrawals during an annuity’s accumulation phase are generally taxable as income to the extent the cash value of the contract immediately before withdrawal (determined without regard to surrender charges) exceeds the investment in the contract. Taxable withdrawals will not result in adjustments to the investment in the contract.

- Loan/Pledges. A loan from the contract or an assignment or a pledge of the contract is taxed similarly to a withdrawal, except that the investment in the contract increases by the amount of the loan/pledge included in gross income.¹⁵

- 5. Check for the Penalty on Early Withdrawals.** Code §72(q) imposes an additional 10% penalty tax on the taxable portion of any “premature” distribution from an annuity contract, including withdrawals, loans or pledges. Notable exceptions to this penalty include distributions: (1) made on or after the taxpayer attains age 59½; (2) made on or after the contract owner's death (or the primary annuitant's death if the owner is not an individual); (3) attributable to the taxpayer's becoming disabled; (4) made under an immediate annuity contract; and (5) made as part of a series of “substantially equal periodic payments” for the life/life expectancy of the taxpayer or joint lives of the taxpayer and designated beneficiary.

Planning Point: As intended, this penalty tax, on top of the LIFO taxation of withdrawals, effectively deters the use of deferred annuities as short-term investment vehicles, making them better suited for longer-term investment horizons.

- 6. Contracts From Same Issuer in Same Year Aggregated.**¹⁶ For purposes of taxing non-annuity amounts during the accumulation phase, all annuity contracts issued by the same insurance company to the same owner in the same calendar year are treated as one contract. As illustrated below, this rule limits use of the LIFO rule for taxation of withdrawals by preventing contract owners from purchasing several contracts but making substantial withdrawals from a single contract to then obtain a nontaxable return of the investment in the contract.

Example. Michael purchases three deferred annuity contracts from insurance company X Co. in the same year. His investment in each contract is \$100,000. One year later, each contract has earned \$10,000 of net income (total of \$30,000 for all contracts) and has \$110,000 of cash value. Michael withdraws \$20,000 from Contract 1. As this amount is less than the total income on all three contracts, the \$20,000 is fully taxable and subject to the 10% penalty. Without this rule, Michael would be taxed only on the \$10,000 of earned income, with the remaining \$10,000 treated as a return of his investment in Contract 1.

- 7. No Income Tax, No Net Investment Income (NII) Tax.** For purposes of the 3.8% NII tax, if an amount is not includible in gross income, such as the excludable amount of any annuity payment, then it also is not includible in NII.
- 8. No Required Minimum Distributions (RMDs).** No RMDs are required from nonqualified annuities at a specified age, as contrasted with certain tax-qualified annuity arrangements (e.g., IRAs) that require RMDs when an individual attains age 70½.
- 9. Complete Surrenders – Ordinary Income Tax on Contract Gain.** Amounts received under an annuity contract upon its complete surrender are taxable as ordinary income to the extent they exceed the contract owner's investment in the contract (as reduced by the portion of any prior annuity payments excluded from gross income based on the exclusion ratio).¹⁷
- 10. Natural Persons as Owners, with Exceptions.** Code § 72(u) taxes the inside build-up on an annuity contract as that build-up accrues unless the contract is held by a “natural person.”¹⁸ Certain exceptions apply, including for annuity contracts that are: (1) immediate annuities; (2) held (including as a nominal owner) by a trust or other entity as an agent for a natural person (e.g., certain grantor trusts; non-grantor trusts where all beneficiaries are natural

persons);¹⁹ (3) acquired by the estate of a decedent because of death; or (4) held in certain qualified or individual retirement plans.

11. Death Can Trigger Distributions and Taxes. Death of the contract owner will trigger certain distribution requirements and tax consequences.

- *Required Distributions.* To qualify as an annuity under Code § 72, the contract must require the following distributions upon the contract owner's death:²⁰
 - Death Before Annuity Starting Date. The remaining contract interest must be distributed to the designated beneficiary (whether in a lump sum or multiple payments) within five years after the owner's death.
 - Death On/After Annuity Starting Date. The contract must provide for distribution to the designated beneficiary of any remaining contract interest at least as rapidly as the method of distribution in effect at the contract owner's death.
 - Exception for Payments over Beneficiary's Life Expectancy. In either case, the designated beneficiary can elect to take distributions of the remaining contract interest over his or her life expectancy, to begin within one year of the owner's death.²¹ Depending on the age of the beneficiary, this could maximize tax deferral.
 - Exception for Surviving Spouse. If the spouse is the designated beneficiary, he or she can be treated as the contract owner following the original contract owner's death, which delays application of the above distribution rules until the surviving spouse's death (and possibly enhances the potential tax deferral).
- *IRD Considerations.* Payments made on a deferred annuity due to the holder's death are income in respect of a decedent ("IRD")²² and are (1) taxable income to the recipient, to the extent that the proceeds exceed the investment in the contract; (2) included in the gross estate of the holder; and (3) not generally eligible for a step-up in basis on the holder's death.²³ A Code § 691(c) IRD income tax deduction should be available for any estate tax on the taxable income portion of the annuity, which provides some relief for the double income/estate taxation.
- **Planning Point:** Given the IRD exposure, annuities may not be the most efficient wealth transfer vehicles, although advance planning can mitigate some of the impact. For example, a charitably-inclined contract holder could designate a charity as the beneficiary of any remaining contract benefits, which should avoid IRD and qualify for an estate tax deduction. Alternatively, the contract holder could name a designated beneficiary who is in a lower tax bracket (and who also may be younger, to maximize deferral) and leave non-IRD assets to beneficiaries in higher brackets.

12. Gifts Can Trigger Income Tax.²⁴ In addition to any gift tax, a gift of an annuity can trigger income tax to the donor on the excess of the contract's cash surrender value over the donor's investment in the contract (a tax result similar to the surrender of the contract). The recipient's investment in the contract (as carried over from the donor), however, will increase, to the extent income on the contract is taxed to the donor under this rule. Note that this rule does not apply to gifts between spouses, transfers between spouses incident to a divorce, or transfers between an individual and his/her grantor trust.

REMEMBER - CHECK THE DATE

As the tax rules applicable to annuities have changed over time, many of the above rules will apply only to annuity contracts issued, or contributions made, after certain dates (see notes herein for examples). Make sure to check the dates on older annuity contracts whenever reviewing the tax consequences of a payment made from, or action taken with regard to, the contract.

TAKE-AWAYS

- Knowledge and active management of nonqualified annuities can extend their potential tax deferral and mitigate the income tax obligations associated with these contracts.
- This places a premium on insurance advisors who have familiarity with the income tax issues and can work with experienced tax advisors to help ensure proper management of the potential tax exposure.

NOTES

¹ This report summarizes some of the tax rules applicable to commercially sold, nonqualified annuities purchased for cash and is not intended as a complete analysis of all tax rules applicable to such annuities. Further, it does not deal with tax-qualified annuities (i.e., those funded with pre-tax dollars) or “private” annuities (or similar arrangements) that do not involve issuance of an annuity by an insurance company.

² Note that variable annuities are considered securities under federal law and subject to applicable regulation.

³ See Treas. Reg. § 1.72-7(a). An annuity contract contains a refund feature if: (1) the total amount receivable as an annuity under such contract depends, wholly or partially, on the continuing life of one or more persons, (2) the contract provides for payments to be made to a beneficiary or an annuitant’s estate after the death of the annuitant if a specified amount or set number of payments has not yet been paid, and (3) such payments are in the nature of a refund of the consideration paid (Treas. Reg. § 1.72-11(c)(1)).

⁴ To be taxed as annuity payments, the payments must be: (1) received on or after the annuity starting date; (2) payable in periodic installments at regular intervals (annually, monthly, etc.) for over a full year from the annuity starting date; and (3) except for variable contracts, determinable, in total amount, as of the annuity starting date based on the terms of the contract or through use of mortality tables and/or compound interest computations (see Treas. Reg. § 1.72-2(b)(2)).

⁵ Code § 72(a)(1) and (b); Treas. Reg. § 1.72-3.

⁶ Code § 72(b)(1).

⁷ See Treas. Reg. § 1.72-5 and the applicable tables in Treas. Reg. § 1.72-9. Example assumes all investment in the contract occurred after June 30, 1986. For contracts with investment in the contract prior to July 1, 1986, different tables under Treas. Reg. § 1.72-9 apply.

⁸ Treas. Reg. § 1.72-7.

⁹ Treas. Reg. § 1.72-2(b)(3).

¹⁰ See Code § 72(a) and (b)(2). Only for annuity contracts with annuity starting dates after December 31, 1986.

¹¹ Code § 72(b)(3).

¹² Treas. Reg. § 1.72-11(c).

¹³ Code § 72(e)(2)(A).

¹⁴ For annuity contracts entered into after August 13, 1982.

¹⁵ Code § 72(e)(4)(A).

¹⁶ Code § 72(e)(12)(A). For annuity contracts issued after October 21, 1988.

¹⁷ Code § 72(e)(5)(E).

¹⁸ To the extent that there are contributions made after February 28, 1986.

¹⁹ See e.g., PLRs 199905015, 9752035, 9639057, 9322011, 9316018 (grantor trusts); PLRs 201124008, 200626034, 200449013 through -17 (non-grantor trusts where all beneficiaries were natural persons).

²⁰ Code § 72(s). For annuity contracts issued after January 18, 1985.

²¹ Code § 72(s)(2).

²² See e.g., Rev. Rul. 2005-30.

²³ Note that variable annuity contracts issued before October 21, 1979 may be eligible for a “step-up” in income tax basis.

²⁴ Code §72(e)(4)(C). For annuity contracts issued after April 22, 1987.

DISCLAIMER

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