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What You Need to Know About Annuities

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David W. Russell, CFP, CSA

David is Market President with Argent Trust in Ridgeland, Mississippi and the editor of ***Wealth and Honor*** (wealthandhonor.com), an online resource for families facing the financial challenges of age transitions. He has been providing financial advice to individuals, families, and institutions since 1984.

At 24 years of age, David took an interest in the relatively new field of financial planning and later earned his Certified Financial Planner (CFP®) designation in 1987 and his Certified Senior Advisor (CSA®) designation in 2017. He has spent most of his career helping families plan for their future, focusing on financial planning, estate plan design, and trust management.

Throughout his thirty plus year career, David has counseled several hundred families, businesses, and individuals on how to achieve their financial and life goals. He is a frequent speaker and is well regarded for his ability to communicate complex issues into understandable language.

In 2012, he authored his first book, What You Need to Know: The Adult Child's Guide to Becoming an Effective Financial Caregiver and began to focus much of his career on helping families facing the financial issues of age transitions. This led to the Certified Senior Advisor designation in 2017.

The Certified Senior Advisor certification and education programs are developed through a rigorous practice analysis/research study involving hundreds of professionals who work with the older adults from the academic community, industry practitioners, regulators, business and non-governmental organizations. Dually accredited by the American National Standards Institute (ANSI) and the National Commission for Certifying Agencies (NCCA), the CSA credential applies to professionals in all areas of the aging industry.

Annuities in Retirement Income Planning

For much of the recent past, individuals entering retirement could look to a number of potential sources for the steady income needed to maintain a decent standard of living:

- **Defined benefit (DB) employer pensions:** In these plans the employer promises to pay a specified monthly amount for the life of the retiree and/or spouse.
- **Social Security:** Designed to replace only a part of an individual's working income, Social Security provides a known benefit for the life of a retiree and his or her spouse.
- **Defined contribution (DC) plans:** Such as 401(k), 403(b), or 457[1] plans, which allow for contributions from the employee (in some cases from the employer as well) to a retirement account. The funds in the account, whatever they amount to at retirement, provide retirement income.
- **Individual retirement plans:** Such as Traditional IRAs or Roth IRAs. These are "individual" versions of employer-sponsored DC plans. The funds in the IRA at retirement, whatever the amount, are used to provide retirement income.

The Changing Face of Retirement

The saying that "life is what happens when you're making other plans" is particularly true when it comes to retirement income planning, for several key reasons:

- **Fewer employer pensions:** Over the past several decades, many employers have changed from defined benefit to defined contribution plans. From 1985 to 2000, for example, the rate of participation in defined benefit plans by full-time employees of medium and large private firms dropped from 80% to 36%.[2] A survey by the Bureau of Labor Statistics, published in 2018, found that only 22% of civilian workers in the U.S. participated in defined benefit pension plans.[3]

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[1] These refer to the sections of the Internal Revenue Code which authorize these different types of retirement plans.

[2] See, "Employee Participation in Defined Benefit and Defined Contribution Plans, 1985-2000." U.S. Bureau of Labor Statistics, updated June 16, 2004.

[3] National Compensation Survey: Employee Benefits in the United States, March 2018, Table 2.

- **Social Security:** Social Security is a "pay-as-you-go" system, with current workers supporting those already receiving benefits. As the baby boom generation retires, the number of individuals remaining in the workforce to support them grows smaller. Although politically unpleasant, fiscal reality may force higher payroll taxes, reductions in benefits, or both.

- **We're living longer:** A child born in 1900 had an average life expectancy of 47.3 years. For a child born in 2014, however, average life expectancy had increased to 78.9 years.[1]

With the stable, lifetime income stream from employer pensions and Social Security playing an ever shrinking role, retirement income planning demands that each individual accept a higher degree of personal responsibility for both accumulating and managing the assets needed to pay for retirement. And managing these assets has to be done in a world where constant inflation, fluctuating interest rates, and sometimes volatile financial markets are a fact of life.

Longer lives mean the money has to last longer, although exactly how long is unknown.

One Possible Answer – Immediate Annuities

Life insurance is designed to help solve the problems created when someone dies prematurely. An annuity, on the other hand, is designed to protect against the possibility of living too long. An "immediate" annuity is a contract between an individual and an insurance company. In exchange for a single, lump-sum premium, the insurance company agrees to begin paying a regular income to the purchaser for a period of years or for life. The periodic payment amount depends on a number of factors:

- **Premium paid:** Generally the larger the payment, the larger the income stream.

- **Age:** Older individuals typically receive larger periodic payments.

- **Payout period selected:** A shorter payout period usually results in a larger payment.

- **Underlying investment medium:** Generally, either a fixed or a variable annuity.

[1] Source: National Vital Statistics Reports, Volume 66, Number 4. United States Life Tables, 2014, Table 19. August 14, 2017.

FIXED ANNUITY	VARIABLE ANNUITY
A fixed annuity pays a fixed rate of return. The insurance company invests in a portfolio of debt securities such as mortgages or bonds and pays out a fixed rate of return. Generally, this rate of return is guaranteed for a certain period of time after which a new rate is calculated. Most insurance companies offer a guaranteed minimum rate throughout the life of the contract. Such guarantees are based upon the claims-paying ability of the issuing insurance company.	A variable annuity offers the potential for higher returns in exchange for assuming a higher level of risk. You can choose from among several types of investment portfolios, such as stocks or bonds. The amount of each annuity payment will fluctuate depending on the performance of the underlying investments. Variable annuities are long-term investments designed for retirement purposes. They have certain limitations, exclusions, charges, termination provisions, and terms for keeping them in force, and are sold by prospectus only.[1]

Annuities are not insured by the FDIC or any government agency. Since an annuity may be payable far into the future, dealing with a financially solid insurer is essential. Credit rating companies such as A.M. Best, Standard and Poor's, or Moody's can provide an objective measure of a firm's financial stability.

Seek Professional Guidance

For many individuals, an immediate annuity can form an important part of their retirement income planning. Because an immediate annuity is a complex product, the advice and guidance of a trained financial professional is highly recommended.

[1] The prospectus for a variable annuity contains complete information including investment objectives, risk factors, fees, surrender charges, and any other applicable costs.

Deferred Annuities

What Is a Deferred Annuity?

Life insurance is used to create an estate for an individual if he or she dies too soon. A deferred annuity, however, can provide protection against the possibility that an individual will live too long and outlive his or her accumulated assets.

The term "annuity" derives from a Latin term meaning "annual" and generally refers to any circumstance where principal and interest are liquidated through a series of regular payments made over a period of time. A "deferred" annuity is an annuity in which both the income, and any taxes due on growth inside the contract, are pushed into the future, until they are actually received by the owner.[1]

A commercial[2] deferred annuity is a special type of policy issued by an insurance company. In a typical situation, the policyowner contributes funds to the annuity. The money put into the policy is then allowed to grow for a period of time. At a future date, the policy may be "annuitized" and the accumulated funds paid out, generally through periodic payments made over either a specified period of time, or the life of an individual, or the joint lives of a couple.

Parties to an Annuity

There are four parties involved in a typical annuity:

- **Insurance company:** This is the issuer of the annuity.
- **Policyowner:** This is the individual or entity that contributes the funds. The policyowner typically has the right to terminate the annuity, to gift it to someone else, to withdraw funds from it, and to change the annuitant or beneficiary. Depending on the type of annuity, a policyowner may have other rights as well.

[1] Under federal law, the deferral of income tax on growth inside the policy is available only to natural persons; the tax-deferral is generally not permitted if the annuity owner is a non-natural person such as a trust or corporation.

[2] A private annuity is an agreement between individuals, usually exchanging a valuable asset (such as a business) for a lifetime income. The party promising to pay the annuity is someone who is not in the business of issuing annuities.

- **Annuitant:** This is the individual whose life is used to determine the payments during annuitization. An annuity will remain in force unless terminated by the owner, or as a result of the death of the owner, or the annuitant dies.

- **Beneficiary:** This is the individual or entity that receives any proceeds payable on the death of the annuitant or the policyowner, depending on whether the annuity is "annuitant driven" or "owner driven."

A single individual may be the policyowner, annuitant, and the beneficiary, although this is not usually recommended. More commonly, these roles are held by different individuals or entities.

Types of Deferred Annuities

There are many different ways to classify deferred annuities:

- **Method of purchase:** Annuities can be purchased with a single lump-sum of cash; such annuities are often referred to as single premium annuities. They may also be purchased with installment payments over time, either of a fixed dollar amount on a regular basis or with flexible payments.

- **When annuity payments begin:** Payments under a deferred annuity typically begin at some future time. In comparison, an "immediate" annuity, is purchased with a single premium, with annuity payments beginning one payment period (monthly, annual, etc.) later.

- **Investment options:** During the period before a policy is annuitized or completely liquidated, the funds invested by the policyowner are put to work. Depending on the type of annuity, the underlying investment vehicle will vary.

    - **Fixed annuity:** In a fixed annuity, the issuing life insurance company will guarantee a certain rate of interest, for a specified period of time, typically 1-10 years. Such annuities are useful for conservative, risk-averse individuals. The investment risk rests on the insurance company and any annuity payments are relatively predictable.

- **Variable annuity:** A buyer of a variable annuity has the option of placing the funds in the policy in a variety of investment options. The investment risk rests largely on the policyowner. Annuity payments are linked to the value of the underlying investments, which can fluctuate up or down.

- **Indexed annuity:** An indexed annuity is a type of fixed-rate annuity which combines a guaranteed minimum interest rate with a potential for greater growth, with returns being based on a formula related to a specific market index such as the Standard & Poor's 500 index. If the chosen index rises sufficiently during a specific period, a greater rate is credited to the policyowner's account for that period. Unlike variable annuities, where poor market performance can lead to decreased policy values, indexed annuities are structured to not lose value due to a declining stock market. However, because of surrender charges, an investor may lose principal value if an indexed annuity is surrendered early.

Payments from an Annuity

There are a number of ways that money may be withdrawn or received from a deferred annuity:

- **Lump-sum withdrawal:** A policyowner can withdraw all of the funds in an annuity in a single lump sum. Such a withdrawal is considered a surrender of the policy and the annuity ends. Depending on the policy and the length of time it has been in force, the insurance company may impose surrender charges, generally expressed as a percentage of the balance.

- **Partial withdrawal:** Many annuity policies allow an owner to withdraw a certain portion of the balance each year (usually 10% - 15%), without a surrender charge.

- **Partial annuitization:** Federal income tax law allows a portion of a nonqualified annuity contract, endowment, or life insurance contract to be annuitized while the balance is not annuitized, provided that the annuitization period is for 10 years or more, or is for the lives of one or more individuals.

- **Life only annuity:** Regular payments are made for as long as the annuitant lives. When the annuitant dies, payments cease and no refund is made, even if the policyowner has not recovered the initial investment.

- **Life with term certain:** Regular payments are made for the life of the annuitant, or a specified number of years. If the annuitant dies before the specified term has passed, annuity payments continue to a beneficiary for the remainder of the term.
- **Joint and survivor:** Regular payments are made over the lives of two individuals. When one dies, annuity payments (or a specified portion) continue to the survivor.
- **Refund options:** Regular payments are made over the life of the annuitant. However, if the annuitant dies before the policyowner's investment has been recovered, the balance is refunded to a named beneficiary through either a lump-sump payment or continued annuity payments.
- **Specified period:** Regular payments are made for a pre-selected number of years. If the annuitant dies before the specified period has expired, payments are continued to a named beneficiary for the remaining term.
- **Specified amount:** Payments of a set amount are paid out regularly as long as there is money in the account.

Taxation of Annuity Payments

The tax treatment of payments made from a deferred annuity will vary, depending on whether the funds used to purchase the annuity have been taxed or not,[1] and on where in the life cycle of the annuity the payments are made. In general, the following rules apply:[2]

- **Before annuitization:** Funds withdrawn from an annuity prior to annuitization are considered to be made first from interest or other growth.[3] These earnings are taxable as ordinary income. If the annuity owner is under age 59½ at the time a withdrawal is made, the earnings are also subject to a 10% federal tax penalty, unless an exception applies. If earnings are completely withdrawn and payments are then made from the owner's initial investment, the payment is treated as a tax-free recovery of basis.

[1] "Qualified" annuities are annuities purchased inside of a retirement plan such as a 401(k) or IRA, generally with pre-tax funds. "Nonqualified" annuities are purchased outside of an IRA or retirement plan, with money that has already been taxed. The taxation discussion here concerns nonqualified annuities.

[2] This information is based on federal law. State law may vary.

[3] Withdrawals from annuity policies entered into before August 14, 1982 were treated as first coming from principal, to the extent of premiums contributed before August 14, 1982.

- **After annuitization:** Regular annuity payments are treated as being composed of part earnings and part return of investment. The earnings portion is taxable as ordinary income. Once the owner has completely recovered his or her investment, all remaining payments are fully taxable as ordinary income. In some situations, if the owner is under age 59½ when payments are received, a 10% federal penalty tax may apply.

- **Estate taxes:** Any amount payable to a beneficiary under an annuity by reason of an owner's death is includible in the owner's gross estate. If an annuitant/owner receiving payments under a life-only annuity dies, no further payments are due and nothing is includible in his or her estate.

Other Common Annuity Provisions

There are several standard provisions commonly found in annuity policies:

- **Bailout provision:** The bailout provision applies only to fixed annuity policies. In a fixed annuity, an insurer will typically offer a guaranteed rate of interest for a specified period of time. For any subsequent time periods, a different rate of interest will usually be offered. Under the bailout provision, generally, if a renewal interest rate is more than 1% less than that offered in the previous period, the policy owner has the option of terminating the policy without paying any insurance company surrender charges. Interest or other growth withdrawn will generally be subject to current income tax and may also be subject to the 10% penalty tax if taken before age 59½.

- **Surrender charges:** Most commercial annuities do not charge a commission when an annuity is purchased. Many, however, impose a surrender charge if withdrawals in excess of a certain amount are made, or if the policy is surrendered completely. Surrender charges can range from 0% to 10% and typically decline over time.

- **Prospectus:** Variable annuities are considered by the Securities and Exchange Commission (SEC) to be a security. The SEC requires that the purchaser of a variable annuity be given a prospectus, which provides detailed information on how the annuity works, the investment options available, the risks involved, and any expenses or charges. The SEC also requires individuals selling variable annuities to be licensed to sell securities.

Certain optional provisions may be available by paying an additional charge:

- **Guaranteed death benefit:** The guaranteed death benefit provision applies only to variable annuities. If an annuitant, or owner in some contracts, dies before annuity payments begin, the policy will pay the named beneficiary the greater of the investment in the policy (less any withdrawals) or the policy value on the date of death.
- **Enhanced death benefit:** Some variable annuities offer an enhanced death benefit option. This feature provides that upon the death of the annuitant, or owner in some contracts, the beneficiary will receive the greater of the policy's value on the date of death, or the original principal (plus any additions) compounded at 5% per year. Other enhanced death benefits include percentage increases and highest anniversary valuation.

Seek Professional Guidance

Deferred annuities are primarily intended to be long-term investments. Because of this, and because of the complexity of many annuity policies, an individual considering the purchase of a deferred annuity should carefully consider all aspects. The guidance of appropriate tax, legal, and other advisors is highly recommended.

Indexed Annuities

The term "annuity" derives from a Latin term meaning "annual" and generally refers to any circumstance where principal and interest are liquidated through a series of regular payments made over a period of time. A tax-deferred annuity is an annuity in which taxation of interest or other growth is deferred until it is actually paid.[1]

A commercial[2] tax-deferred annuity is a contract between an insurance company and a contract owner. In a typical situation, the contract owner contributes funds to the annuity. The money put into the contract is then allowed to grow for a period of time. At a future date, the contract may be "annuitized," when the accumulated funds are paid out, generally through periodic payments made over either a specified period of time or the life of an individual or the joint lives of a couple.

An indexed annuity is a type of annuity that grows at the greater of an annual, guaranteed minimum rate or the return based on a formula related to a specific market index. Annuity contract guarantees are based on the claims-paying ability of the issuing insurance company.

Fixed vs. Indexed Annuities

Two primary annuity types are the fixed and variable annuities. (An indexed annuity is a type of fixed-rated annuity.) Although these annuities share many features in common, the primary difference between them is in the mechanism used to credit earnings to the annuity:

- **Fixed annuities:** Fixed annuities are characterized by a minimum interest rate guaranteed by the issuing insurance company. Typically, a minimum annuity benefit is also guaranteed. With a fixed annuity, the focus is on safety of principal and stable investment returns.

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[1] Under federal law, the deferral of income tax on growth inside the contract is available only to natural persons; the tax deferral is generally not permitted if the annuity owner is a non-natural person such as a trust or corporation, unless the owner is an agent for a natural person.

[2] In comparison, a private annuity is an agreement between individuals, usually exchanging a valuable asset (such as a business) for a lifetime income. The party promising to pay the annuity is someone who is not in the business of issuing annuities.

Indexed Annuities

- **Indexed annuities:** In contrast, indexed annuities (IA) are characterized by a contract return that is the greater of an annual minimum rate (typically 3%) or the return based on a formula related to a specific market index, such as the Standard & Poor's 500 index, reduced by certain expenses. If the chosen index rises sufficiently during a specific period, a greater return is credited to the contract owner's account for that period. If the market index does not rise sufficiently, or even declines, the lower minimum rate is credited. An owner is guaranteed to receive back at least all principal, if an IA contract is held for a minimum period of time, known as the penalty period. The penalty period for some indexed annuity contracts can be quite lengthy.

Understanding Indexed Annuities

Although all indexed annuities share the same objective, contracts can vary greatly. The specific structure of a contract will affect the amount and timing of growth in the contract, as well as its liquidity. Below are definitions of some common IA terminology:

- **Term:** This is the length of time the penalty period lasts and/or the time when the investor has the option to renew. The period is commonly three to seven years.

- **Participation rate:** Also known as the "index rate," the "participation rate" is the percentage increase in the index by which a contract will grow. For example, "75% of the S&P's increase for the calendar year" means that if the S&P 500 index increases 10% for the year, the contract would be credited with 7.5%. This rate is usually less than 100%. The participation rate is subject to change by the insurance company.

- **Administrative fee:** This is also known as an annual fee, spread yield, or expense load. It is a fixed charge subtracted annually by the insurer. This fee ranges from 1.0% to 2.25%.

- **Cap rate:** This is the annual maximum percentage increase allowed. For example, if the chosen market index increases 35%, a contract with a 9.0% cap rate will limit the client's increase to 9.0%. The cap rate is subject to change by the insurance company. Some contracts do not have a cap rate.

- **Floor:** This is the minimum guaranteed amount credited to the contract, typically in the three to four percent range. The investor will receive this minimum amount only if the IA is held for a specified, minimum period of time.

- **Reference (contract) value:** This is the amount the investor is entitled to, i.e., the greater of the current account value less any remaining surrender charges.
- **Anniversary date:** This is the beginning of the term used to measure the growth in a contract.
- **Index credit period:** Amounts are credited to a contract at specific points in time. The three most common period methodologies used to determine the credited amount are as follows.
    - **Annual reset:** This measures the change in the market index over a one-year period.
    - **Point-to-point:** While similar to annual reset, the period used is usually five years.
    - **Annual high watermark with look back:** While similar to point-to point, the highest annual anniversary value[1] is used to determine the gain instead, i.e., the largest number at the end of any of the five years.
- **Averaging:** Some indexed annuities will determine any increased contract value based on an average of the monthly changes in the market index, measured over a specified period.

Other Issues

Other issues to keep in mind include the following:

- **Guaranteed death benefit:** Some contracts offer, as an optional feature, a guaranteed death benefit. If an annuitant dies before annuity payments begin, the contract will pay the named beneficiary the greater of the investment in the contract (less any withdrawals) or the contract value on the date of death.
- **Contract fees and charges:** Although there is typically no commission charged when an indexed annuity is purchased, these contracts are subject to a number of fees and charges. These include administrative and mortality risk charges to cover the insurer's basic expenses as well as the cost of any guaranteed death benefit provisions. Surrender charges may also be imposed if withdrawals in excess of a certain amount are made or if the contract is surrendered. Surrender charges can range from 0 to 15% and typically decline over time. Payment of a surrender charge may result in a redemption less than the principal amount invested.

[1] For example, the credited amount might be the largest number at the end of any of the five years.

Taxation of Annuity Payments

The tax treatment of payments made from an annuity will vary, depending on where in the life cycle of the annuity the payments are made. In general, the following rules apply:[1]

- **Before annuitization:** Funds withdrawn from an annuity contract prior to annuitization (i.e., the beginning of regular payments) are considered to be made first from interest or other growth.[2] These earnings are taxable as ordinary income. If the annuity owner is under age 59½ at the time a withdrawal is made, the earnings are also generally subject to a 10% federal tax penalty.[3] If earnings are completely withdrawn and payments are then made from the owner's initial investment, the withdrawal is treated as a tax-free recovery of capital.

Changes to the annuity contract, including loans, collateral assignments, and ownership changes may also result in income tax consequences.

- **After annuitization:** Regular annuity payments are treated as being composed of part earnings and part return of capital. The earnings portion is taxable as ordinary income. Once the owner has completely recovered his or her investment in the contract, all remaining payments are fully taxable as ordinary income. Income amounts paid before the owner attains the age 59½ are generally subject to a 10% federal tax penalty, unless the annuitization is made for the owner's life or life expectancy.

- **Estate taxes:** Any amount payable to a beneficiary under an annuity contract by reason of an owner's death is includable in the owner's gross estate. If an annuitant/owner receiving payments under a life-only annuity contract dies, no further payments are due and nothing is includable in his or her estate.

- **Income in respect of a decedent:** Payments are still subject to income tax when received by the beneficiary. However, the beneficiary may also be eligible for a federal income tax deduction for a portion of the estate tax paid.

[1] Based on federal law. State law may vary.

[2] Withdrawals from annuity contracts entered into before August 14, 1982 were treated as first coming from principal, to the extent of premiums contributed before August 14, 1982.

[3] Two exceptions to the 10% penalty involve the death or disability of the contract owner.

Seek Professional Guidance

Tax-deferred annuities are primarily intended to be long-term investments. Because of this and the complexity of many annuity contracts, an individual considering the purchase of a tax-deferred annuity should carefully consider all aspects before entering into the contract. The guidance of appropriate tax, legal, and other financial professionals is highly recommended.

Taxation of Nonqualified Annuities

The term "annuity" refers to any situation where principal and interest are paid out in a series of regular payments. A "nonqualified" annuity, generally, is an annuity purchased by an individual from a life insurance company outside of an IRA or a qualified plan.[1] Many individuals purchase these annuities to provide a retirement income stream they cannot outlive.

Nonqualified annuities can be classified in a number of ways:

- **How purchased:** They can be purchased with a single, lump-sum payment, or with a series of payments made over time.
- **Underlying investment:** With a "fixed" annuity, the annuity owner's funds are placed in the insurance company's general investment account. In a "variable" annuity, these funds are placed in special investment subaccounts, as directed by the contract owner. Variable annuities are long-term investments designed for retirement. The value of the investment options chosen will fluctuate and, when redeemed, may be worth more or less than the original cost. A withdrawal charge may apply.
- **When payments begin:** An annuity can be "immediate," with payments beginning within one year of a contract being issued, or it can be "deferred," with payments beginning after an accumulation period, at a future date commonly called the "annuity starting date."
- **How long payments are made:** Payments can be made for a fixed period of time (e.g., 15 years), over the life or lives of specified individuals, or a combination of the fixed and lifetime options. (e.g., the longer of 15 years or until the annuitant[2] dies).

Unlike currently taxable investments, as long as the funds are kept **inside** the annuity, there is generally no federal income tax liability.[3] The tax "bite" is deferred until the funds are

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[1] By way of contrast, a "private" annuity is an agreement between individuals, usually exchanging a valuable asset (such as a business) for a lifetime income. The party promising to pay the annuity is someone who is not in the business of issuing annuities.

[2] The "annuitant" is the individual whose life is used to determine how long payments will be made. Frequently the owner and the annuitant are the same individual.

[3] The discussion here concerns federal income tax law. State or local law can vary. Under federal income tax law, the deferral of tax is, with a few, narrow exceptions, not permitted if the annuity owner is a non-natural person such as a corporation or trust.

withdrawn from the contract. Depending on how and when the funds are distributed, the income and/or estate tax impact can vary.

Amounts Not Received As an Annuity – Before Annuity Starting Date

Sometimes funds are withdrawn from the contract that are not periodic annuity payments. Such distributions may take the form of cash withdrawals, dividends, loans, or a partial surrender of the contract. If funds are withdrawn from a nonqualified annuity before the annuity starting date, the annuity owner must include in income the **smaller** of:

- The amount distributed, or
- The amount by which the cash value of the contract exceeds the owner's investment in the contract. In other words, as funds are distributed the **earnings are taxed first**.

Example: Sally Smith bought a nonqualified annuity several years ago for $11,000. Before the annuity starting date, she takes a cash distribution of $6,000. At the time of the distribution, the cash value of the contract is $15,000. The distribution is allocated first to earnings, so Sally includes $4,000 ($15,000 - $11,000) in her gross income. The remaining $2,000 is received as a tax-free return of her investment.

Distributions Before Age 59½ - 10% Penalty

If funds are distributed from an annuity before the owner reaches age 59½, an additional tax of 10% may be levied on that part of a distribution that is included in gross income.

Example: If Sally had been age 58 when she took her $6,000 distribution, she would have had to pay an additional tax of $400, 10% x the $4,000 included in her gross income. The 10% penalty would not apply to the $2,000 that represented a return of her original investment.

Not all distributions before age 59½ are subject to the 10% premature distribution penalty. Federal income tax law contains a number of exceptions, [1] including distributions which are:

- Made **after** the taxpayer reaches age 59½.

[1] See IRC Sec. 72(q) for a complete list of the exceptions to the 10% penalty. IRS Publication 575, Pension and Annuity Income, has a "plain English" discussion of the 10% penalty and the exceptions to it.

- Made as a part of substantially equal periodic payments for the life (or life expectancy) of the taxpayer (contract owner) or the joint lives (or joint life expectancy) of the taxpayer and a designated beneficiary.
- Made because of the contract owner's total and permanent disability.
- Made because of the death of the contract holder (or primary annuitant if the holder is a non-natural person).
- Made from an immediate annuity, in which payments (made at least annually) must begin within one year of the contract's purchase date.
- Allocable to an investment in the contract before August 14, 1982.

Taxation of Annuity Payments – In General

For periodic payments made after the annuity starting date, each payment is considered to be made up of two parts:

- **Earnings** (dividends, interest, or other growth), which are currently taxable, and
- A **return of the annuity owner's invested funds**, known as the "investment in the contract," which is received income tax free. In simple terms, the investment in the contract is the total amount paid for the contract, less certain amounts received that were excluded from income.

An "exclusion ratio" is calculated which determines how much of each annuity payment is taxable, and how much is income tax free. This ratio is applied to each annuity payment until the owner has completely recovered his or her investment in the contract. Thereafter, each annuity payment is 100% taxable. The examples which follow illustrate how this works.

Fixed Annuities – Exclusion Ratio

In calculating the exclusion ratio, an estimate of the amount to be received must be made. If fixed payments are to be made for a fixed term, the calculation is relatively simple:

> Example: Bill recently bought an annuity which will pay him $500 per month for 10 years, beginning when he reaches age 65. His expected return is $60,000 ($500 per month x 12 months per year x 10 years). If Bill's investment in the contract were $45,000, his exclusion ratio would be 75%, calculated as follows:

$$\frac{\text{Investment in the contract} = \$45{,}000}{\text{Expected return} = \quad \$60{,}000}$$

For each $500 monthly payment, Bill would exclude $375 ($500 x 75%) from his gross income. The remaining $125 is included in his gross taxable income.

If fixed payments are to be made for the life of one or more individuals, the expected return is calculated using federal government life expectancy tables:[1]

Example: Linda, age 60, purchased an immediate annuity which was to pay her $400 per month for the rest of her life, starting on the date of purchase. Her expected return is $4,800 ($400 per month x 12 months) x the life expectancy in years from Annuity Table V (single life), which is 24.2. Thus the total expected return equals $116,160, ($4,800 x 24.2). If her investment in the contract equals $80,000, her exclusion ratio is 69%, calculated as follows:

$$\frac{\text{Investment in the contract} = \$80{,}000}{\text{Expected return} = \quad \$116{,}600}$$

For each $400 monthly payment, Linda can exclude $276 ($400 x 69%) from her gross income. The remaining $124 is included in taxable income. If Linda lives more than 24.2 years, she will have completely recovered her investment in the contract, and her annuity payments from that point on will be 100% taxable.

Variable Annuities – Proportionate Amount Excluded

In a variable annuity, annuity payments are not a fixed amount; they can vary up or down as the result of fluctuating investment returns or factors such as a cost-of-living index. Because payments vary, it is not possible to calculate, as is done with a fixed payment annuity, an "expected return," in order to determine the exclusion ratio for income tax purposes.

Instead, a proportionate amount of the investment in the contract is allocated to each taxable year. In simple terms, this is calculated by dividing the investment in the contract by the projected number of payments that are to be made. If the dollar amount of annuity payments received in a particular year does not exceed the amount of investment in the

[1] See IRS Reg. 1.72-9.

contract allocated to that tax year, the payments are excluded from taxable income. If the total dollar amount of payments exceeds the amount of investment in the contract allocated for the year, the excess above the allocated amount is taxable.

> Example: Steven pays $20,000 for a variable annuity that will make monthly payments to him over a 10-year period. The projected number of payments is thus 120 (10 years x 12 months per year). The amount of his investment in the contract that is allocated to each monthly payment is $166.67 ($20,000 ÷ 120). If Steven's contract begins making payments to him on July 1, and he receives a total of $1,200 for the year, $1,000.02 ($166.67 x 6) will be excluded from his income. He must include the remaining $199.98 in his gross income for the year.

If a variable annuity makes payments over the life expectancy of one or more individuals, the projected number of payments is calculated using government life expectancy tables.[1]

> Example: Bob, age 65 and Alice, age 59, pay $50,000 for a variable annuity which will make annual payments to them over their joint life expectancy. According to Annuity Table VI (two lives) their joint life expectancy is 28.2 years. The amount of investment in the contract that is allocated to each annual payment is $1,773.05 ($50,000 ÷ 28.2). To the extent that any annual payment exceeds $1,773.05, the excess will be subject to taxation.

Gifting an Annuity

If a taxpayer transfers ownership of an annuity to another person, without receiving full and adequate consideration (e.g., a gift), the transaction is taxable. The transferor (the person making the gift) must include in income the excess of the contract's surrender value on the date of the transfer over the investment in the contract.

> Example: Larry gifts an annuity to his son George. On the date of the transfer, the cash surrender value of the contract was $75,000; Larry's investment in the contract was $60,000. For the year of the transfer, Larry must include in income $15,000 ($75,000 - $60,000).

These rules do not apply to transfers between spouses nor to transfers incident to a divorce.

[1] See IRC Reg. 1.72-9.

Exchanging an Annuity

In some situations, an annuity owner will want to exchange an existing annuity contract for a different contract. For income tax purposes, such exchanges are governed by IRC Sec. 1035. As long as certain requirements are met, these exchanges are tax-free and allow the annuity owner to roll-over any gain in the old contract to the new one.

Complete Surrender of an Annuity Contract

An amount received by a taxpayer for the complete surrender, redemption, or maturity of an annuity is taxable only to the extent that the proceeds exceed the investment in the contract.

> Example: Michael receives $95,000 for the complete surrender of an annuity contract. His investment in the contract is $75,000. In the year of surrender (regardless of when the proceeds are actually received), he must include $20,000 in gross income ($95,000 - $75,000).

Death

The tax treatment of amounts payable from an annuity because of the death of the owner/annuitant will vary, depending on when death occurs:

- **Death before annuity starting date:** Amounts payable at death are generally includable in the decedent's gross estate for estate tax purposes. If a named beneficiary receives the death benefit, the beneficiary must include in gross income the excess of the total amount received over the decedent's cost in the contract. Whether paid to the estate or a named beneficiary, amounts received in excess of the decedent's basis in the contract are income in respect of a decedent (IRD). Any estate tax attributable to the IRD generally qualifies as a Miscellaneous Itemized Deduction.

- **Death after annuity starting date:** Once regular annuity payments have begun, the tax results will depend first on how the annuity payments are to be made. If the annuity is payable for a single life only, once that life has ended there is nothing left to tax. Any unrecovered investment in the contract may be deducted on the decedent's final income tax return. Otherwise, there is neither an estate nor an income tax impact.

For annuity contracts which provide a benefit to those left behind (for example a refund annuity or payments under a joint and survivor contract), the situation is slightly different. If the decedent's estate is to receive the benefits, they are includable in his or her gross estate. If the benefits are payable to a named beneficiary, the value of those benefits is also generally includable in the decedent's gross estate. For income tax purposes, with either a refund or payments to a survivor, the income is generally taxable only when the amounts received exceed the investment in the contract:

- **Surviving spouse is the beneficiary:** If the designated beneficiary (the individual who becomes the new owner of the contract) is the surviving spouse of the deceased owner, IRC Sec. 72(s) lets the survivor "step in the shoes" of the deceased owner, with the distribution requirements applied by treating the surviving spouse as the owner.

Partial Annuitization

Federal income tax law allows a portion of a nonqualified annuity contract, endowment, or life insurance contract to be annuitized while the balance is not annuitized, provided that the annuitization period is for 10 years or more, or is for the lives of one or more individuals.

The investment in the contract is allocated on a pro-rata basis between each portion of the contract from which amounts are received as an annuity, and the portion of the contract from which amounts are not received as an annuity. This allocation is made for the purposes of applying the rules relating to the exclusion ratio and in determining the investment in the contract, the annuity starting date, and amounts not received as an annuity. A separate annuity starting date is determined with respect to each portion of the contract from which amounts are received as an annuity.

Seek Professional Guidance

Commercial, nonqualified annuities are complex investments that can be structured to meet a wide range of needs and situations. Similarly, the federal tax treatment of these investment products is also complex. The guidance of qualified tax and investment professionals is strongly recommended.