Lesson 4 – Income Taxation

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Premiums (or deposits) paid into a non-qualified annuity are not deductible from the annuity holder's income. Thus, if a married couple in their 50's decides to place a certain sum of money into a deferred annuity contract each month as part of their overall retirement plan, the monthly amount will not generate any immediate income tax savings currently, although the interest earned on the funds once they are inside the annuity will be income-tax deferred. This general rule of non-deductibility applies whether the premium is a single payment or paid in installments over many years.

Contributions to "qualified" annuities (contracts held within IRAs or employer-sponsored retirement plans) may be deductible from income tax if certain requirements are met. For example: Contributions to a traditional Individual Retirement Annuity (IRA) may be deducted by the owner if neither the husband nor the wife participates in an employer-provided retirement plan. It may also be deductible even though one or both participate in such a plan as long as the couple's gross income falls within certain limits. Also, a Tax Sheltered Annuity (TSA) plan, often called a 403(b) plan, is available to employees of certain tax-exempt employers and may receive employee contributions on a pre-tax basis. However, the general rule is that premiums used to purchase an individual annuity, whether for retirement planning or other purposes, will not be tax deductible.

CASH VALUE BUILD-UP

Natural Persons

If an annuity contract meets certain requirements of the Internal Revenue Code the interest earned on the funds inside the annuity contract will not be taxed at the time it is credited. This is true only if the owner of the annuity is a natural person, as discussed below. However, the income tax on the annuity funds must be paid at some point. This occurs when the funds are paid out of the contract (i.e., the contract is annuitized) or the contract is surrendered for its full cash value or its value is paid out as a death benefit. Deferred annuities are "tax-deferred", not "tax-free".

Non=natural Persons

If any contributions are made after February 28, 1986 to a deferred annuity contract which is owned by a corporation or other entity which is not considered under the tax law to be a natural person, the interest earned each year on the funds inside the annuity is taxable.

Generally, the amount of interest earned is referred to as "income on the contract." Technically, it is calculated by taking the sum of the net surrender value of the contract at the end of the taxable year and any amounts distributed under the contract during the taxable year and any prior taxable year and subtracting the sum of the net premiums for the taxable year and prior taxable years and any amounts includable in gross income for prior taxable years under this requirement.

There are some types of annuities to which this rule, which is often referred to as “the non-natural person” rule, does not apply. These include any annuity contract which:

- is acquired by a person’s estate at the person’s death
- is held under a qualified retirement plan, a Code section 403(b) Tax Sheltered Annuity (TSA), or an Individual Retirement Arrangement (IRA)
- is purchased by an employer upon the termination of a qualified retirement plan or Tax Sheltered Annuity (TSA) program and held by the employer until all amounts under the contract are distributed to the employee for whom the contract was purchased or to his beneficiary
- is an immediate annuity (an annuity which is purchased with a single premium and begins payments within a year)
- is a qualified funding asset (an annuity contract issued by a licensed insurance company which is purchased to fund payments for damages resulting from personal physical injury or sickness).

As with all rules regarding taxation, there is an exception to this general rule. When an annuity contract is held by a trust, corporation, or other “non-natural” person as an agent for a natural person, the contract will be treated as an annuity and the interest earned will be income-tax deferred.

Since this rule was created in 1986, there have been many questions about its application to certain types of trusts. Generally, the IRS has indicated that it views most types of trusts that have only natural persons as beneficiaries as acting as an agent for the natural persons. Deferred annuity contracts held by corporations as informal funding instruments or a deferred compensation plan have been held in some cases to qualify for the "agent of a natural person" exception.

Another item to remember about the “non-natural person” rule is that it applies only to contributions made to annuity contracts after February 28, 1986. Thus, it seems clear that if all contributions to the annuity are made after this date, the “non-natural person” rule will apply to the contract. It also seems clear that if no contributions are made after this date, a contract held by a non-natural person is treated for tax purposes as an annuity contract and therefore the interest earned inside the annuity is tax deferred. However, if contributions have been made both before and after this date to contracts held by non-natural persons, it is not clear how the situation will be viewed by the Internal Revenue Service.

LOANS AND ASSIGNMENTS

An area of annuity taxation that is somewhat confusing, and can cause some unexpected and sometimes unfortunate income tax results, concerns loans made from annuity contracts *or the assignment of the values in an annuity contract as security for a loan.* Generally, any amount received as a loan or the value of any part of an annuity contract pledged or assigned under a contract entered into after August 13, 1982 is taxable. The amount included in income and, therefore, taxable is calculated by taking the cash value of the contract immediately before the loan or assignment and subtracting the investment in the contract, which is generally equal to the amount of premium that has been paid into the annuity.

The following example illustrates the surprise that awaits an annuity holder who uses his contract as security for a loan. Assume that Mr. Brown purchased an annuity contract in 1984 with a single premium of $50,000. Currently, the annuity's cash surrender value is $75,000. Mr. Brown wishes to borrow from his local bank to assist his twin sons with their educational expenses. He assigns to the bank an interest in the full value of the annuity. At the time of the assignment, Mr. Brown will have taxable income of approximately $25,000. This is calculated by taking the cash surrender value of the annuity immediately prior to the assignment ($75,000) and subtracting Mr. Brown's investment in the contract ($50,000).

It should be noted that loans made from certain specialized types of annuities and plans, such as Tax Sheltered Annuities under Code section 403(b) and qualified retirement plans, are subject to different rules and that loans from Individual Retirement Annuities (IRAs) are prohibited.

Another situation which can result in taxable income to an annuity holder involves an owner who assigns the right to receive the annuity payments to another person while still retaining ownership of the contract. For example: Such an assignment might be attractive to Mrs. Smith who has just re-married. Mrs. Smith lost her first husband ten years ago and, with the proceeds of his life insurance, purchased a single premium immediate annuity which pays her $800 each month. After the marriage, Mrs. Smith wishes to assign the monthly payment to her daughter, Jean. If the assignment is made, Jean will receive the $800 each month. However, without the transfer of the underlying contract, the gratuitous assignment of the income from Mrs. Smith's annuity will not shift the taxability of the income away from Mrs. Smith who is still the owner of the contract. Thus, the annuity payments will be taxable to the owner, Mrs. Smith, even though they are paid to a third party, her daughter. (In a situation such as this, the gift tax consequences of the transfer of the annuity payment each month should also be considered.)

PARTIAL WITHDRAWALS

Contract Surrender Charges

Most annuity contracts impose a surrender charge if funds are removed from the contract by either full or partial surrender within a certain number of years after the annuity contract is purchased. Often, the charges decline slightly each year and eventually no longer apply. For example: An annuity contract might impose a surrender charge of 8% of the amount surrendered during the first contract year, 7% during the second year, 6% in the third year and so on until the charge drops to 1% in the eighth year and then to zero in the ninth year. Imposition of these surrender charges is one reason why annuities must be looked upon as long-term purchases.

The surrender charges imposed by the annuity contract itself are separate from and should not be confused with the 10% penalty tax imposed on premature distributions by the Internal Revenue Code, discussed in the following section. Since this penalty tax generally applies to distributions received prior to age 59 1/2 and the contract surrender charges apply during the first few years after the annuity is purchased, an individual may incur one or both of the penalties, depending on the circumstances. For example: Assume that Mr. Jones, age 65, purchased a deferred annuity last year. If he surrenders the contract this year, he will incur the second year contract surrender charge (7% in the example above) but he will not be subject to the tax code's 10% penalty tax since he is older than age 59 1/2 at the time of the surrender. However, if Mrs. White, age 44, surrenders a deferred annuity contract purchased for her by her parents 20 years ago, it is not likely that any contract surrender charges will still be applicable, but the tax code's 10% penalty will still apply since Mrs. White is younger than 59 1/2.

One final example illustrates the potential cost of surrendering an annuity contract subject to both contract and tax code surrender charges. Assume that Mr. Black purchased a deferred annuity three years ago when he took early retirement at age 55. To date, he has paid $15,000 into the contract, the current value of which is $25,000. If he surrenders the contract now, he will incur surrender charges of $7.000, for a net surrender value of $18,000. His "gain" is $3,000 (the amount he realized upon surrender, less is "investment in the contract" of $15,000). He will be liable for the taxes on that $3,000, plus a penalty tax of $300 (10% of $3,000). Because this was a *total contract surrender*, Mr. Black does not have to pay taxes on the entire contract "gain", but only on the difference between the amount he received upon surrender and his investment in the contract.

A different rule applies to partial surrenders. In that case, the taxable gain reportable by the contract owner is determined without regard to surrender charges. Thus, if Mr. Black had withdrawn $9, 000, the entire amount would be subject to both Ordinary Income and penalty taxes, even if surrender charges had reduced the amount of that withdrawal. For more information on this point and an extensive treatment of the taxation of annuities, see Olsen and Kitces, *The Advisor's Guide to Annuities* (National Underwriter Company, fourth edition, 2014).

10% Premature Distribution Penalty Tax

In order to discourage the use of annuity contracts as short term tax sheltered investments, a 10% tax is imposed on certain "premature" payments under annuity contracts.

The 10% tax applies to the portion of any payment that is taxable. For example: If an annuity contract is surrendered for $50,000 and only $30,000 of this amount is includable in the income of the owner of the contract, then the 10% applies only to the $30,000 amount. Thus, the amount of the penalty tax is $3,000 (and not $5,000). The 10% penalty tax on premature distributions from annuity contracts does not apply to any payment:

1. made after the taxpayer reaches age 59 1/2;
2. attributable to the taxpayer's disability;
3. allocable to investment in the contract before August 14, 1982, including earnings on pre-August 14, 1982 investment;
4. made from a qualified retirement plan (or under a contract purchased by this type of plan) or under a Section 403(b) Tax Sheltered Annuity, or from an Individual Retirement Arrangement (but note that payments from these types of contracts are subject to similar penalties);
5. made after the death of the annuity holder;

6. made under an immediate annuity contract;
7. made from an annuity purchased and held by an employer upon the termination of a qualified retirement plan;
8. under a qualified funding asset (i.e., any annuity contract which is purchased as a result of a liability to pay for damages which resulted from physical injury or sickness); or
9. which is part of a series of substantially equal periodic payments made (not less frequently than annually) for the life or life expectancy of the taxpayer or the joint lives or joint life expectancies of the taxpayer and his designated beneficiary.

The exception listed under number 9 above is one of the most-commonly used methods to take money out of a deferred annuity without incurring the 10% penalty tax.

Basically, this exception allows an annuity holder of any age to begin receiving annuity payments from a contract that will be of the same amount. This amount is calculated using the taxpayer's life expectancy or, in the alternative, the joint life expectancies of the taxpayer and his or her beneficiary. Often this second alternative is used by married couples. Despite its usefulness, this exception for payments received over the taxpayer's lifetime carries some limitations. Basically, payments received under this exception may be "recaptured" if the series of payments is modified for reasons other than the death or disability of the taxpayer. If the modification takes place either before the taxpayer reaches age 59 1/2 or before the end of a five-year period beginning at the time of the first payment (even if the taxpayer has reached age 59 1/2), the tax on the amount recaptured is imposed in the first taxable year of the modification and is equal to the tax which would have been imposed plus interest had the exception not applied.

Taxation of Withdrawals and Surrenders

The taxation of "amounts not received as an annuity" (which includes partial withdrawals and complete contract surrenders) has been complicated by changes in the tax law over the last several decades. To determine the tax treatment of any such distribution, we must first look to the date on which the annuity contract was issued. In general terms, if an annuity was entered into after August 13, 1982, a full or partial surrender will be taxed under what is usually referred to as the "interest first" rule while an annuity entered into prior to this date is taxed under the "cost recovery" rule. The rules, which are explained below, are named for that part of the annuity value which the annuity holder is deemed to have received first. Under the "interest first" rule, the annuity holder is deemed to receive the interest earned inside the annuity contract (the contract "gain") before he recovers his cost in the contract, thus receiving taxable income earlier rather than later. In contrast, under "the cost recovery" rule, the annuity holder is deemed to have received the cost of the annuity before he receives any interest that has accumulated within the contract, thus receiving taxable income later, not earlier.

More specifically, the interest first rule states that amounts received on partial surrender under annuity contracts entered into after August 13, 1982, are taxable as income to the extent that the cash value of the contract immediately before the payment exceeds the investment in the contract. To the extent the amount received is greater than the excess of cash surrender value over the investment in the contract, the amount will be treated as a tax-free return of investment. In effect, these amounts are treated as distributions of interest first and only second as recovery of cost.

Cash withdrawals and amounts received on partial surrender under annuity contracts which were entered into before August 14, 1982 (and allocable to investment in the contract made before August 14, 1982) are taxed under the “cost recovery rule.” Under the cost recovery rule, the taxpayer may receive all such amounts tax-free until he has received tax-free amounts equal to his pre-August 14, 1982 investment in the contract; the amounts are taxable only after such basis has been fully recovered.

A simplified example illustrates the difference in the application of these two rules. Assume that Mrs. Green purchased an annuity for a single premium payment of $50,000. The value of the annuity today is $80,000, resulting in interest earned in the contract of $30,000 ($80,000 surrender value minus the $50,000 single premium). Mrs. Green decides to make a partial surrender of $20,000. If the contract falls under the interest first rule, Mrs. Green will pay income tax on the full $20,000 received as a result of the partial surrender. This is true because amounts coming out of the annuity first are deemed to be interest, so until the partial surrender amount exceeds the interest in the annuity of $30,000, the partial surrender amount will be fully taxable.

In contrast, if the partial surrender is subject to the cost recovery rule, Mrs. Green will not pay income tax on any of the $20,000 that she receives. This is so because no amount received upon surrender is considered taxable until an amount equal to Mrs. Green’s cost (the single premium of $50,000) is withdrawn from the annuity. Since the surrender amount of $20,000 is less than the cost amount of $50,000, no income tax is due. Mrs. Green is deemed to be simply recovering the amount that the annuity cost her to purchase. If, on the other hand, the partial surrender amount is $60,000, rather than $20,000, the excess of the $60,000 surrender amount over the $50,000 cost will be taxable income to Mrs. Green where the annuity is taxed under the cost recovery rule.

For partial surrenders, the cash value of an annuity is determined without regard to any surrender charge and the investment in the contract is, under the general rule, the cost of the annuity less any amounts previously received from the annuity that were properly excluded from income. For full contract surrenders, the amount includable as income is the difference between the amount actually received upon surrender and the owner’s investment in the contract. Further, investment in the contract is increased by loans treated as distributions to the extent the amount is includable in income, but not reduced to the extent it is excludable.

The purpose behind the “interest first” rule applicable to investment in contracts after August 13, 1982, is to limit the tax advantages of deferred annuity contracts to long term investment goals, such as income security, and to prevent the use of tax deferred inside build-up as a method of sheltering income on freely withdrawable short term investments.

As with any change in the tax law that divides contracts into those issued before a certain date and those issued after the date, there are questions about how to treat contracts that have one foot on each side of the date. Regarding the taxation of partial surrenders from annuities, the question arises about how to treat a partial surrender from an annuity that was issued prior to the 1982 cut-off date but which received premium payments after 1982. According to the Internal Revenue Code, amounts received from a partial surrender which are allocable to premiums paid after August 13, 1982 in an annuity contract entered into before August 14, 1982 are treated as received under a contract entered into after August 13, 1982 and are subject to the above "interest first" rule. If an annuity contract has income allocable to earnings on pre-August 14, 1982 and post-August 13, 1982 investments, the amount received is allocable first to investments made prior to August 14, 1982, then to income accumulated with respect to such investments (under the "cost recovery" rule), then to income accumulated with respect to investments made after August 13, 1982 and finally to investments made after August 13, 1982 (under the "interest first" rule).

As a final word on partial surrenders and withdrawals, it is important to note that for the taxation of withdrawals from annuity contracts, as with other taxation issues, different rules apply to amounts received under qualified retirement plans, Section 403(b) annuities, and Individual Retirement Arrangements.

Multiple Annuity Contracts

All annuity contracts entered into after October 21, 1988 which are issued by the same company to the same policyholder during any calendar year will be treated as one annuity contract for purposes of determining the amount of any distribution that is includable in income. This aggregation rule does not apply to distributions received under qualified retirement plans, Section 403(b) annuities, or from an Individual Retirement Arrangement, to multiple annuities purchased in the same year from different companies, or to immediate annuities.

Effect of a Tax Free Exchange

In order to give effect to the grandfathering of pre-August 14, 1982 annuity contracts, a replacement contract obtained in a tax free exchange of annuity contracts succeeds to the status of the surrendered contract, for purposes of determining when amounts are to be considered invested and for computing the taxability of any withdrawals. Investment in the replacement contract is considered made on, before or after August 13, 1982 to the same extent the investment was made on, before or after August 13, 1982 in the replaced contract. For example: Assume that Ms. Brown purchased an annuity with a single premium of $10,000 in 1981 and then, at some point after 1982, exchanged the annuity, via a Code section 1035 exchange, for another annuity. Even though the newly-received annuity was issued after the 1982 cut-off date, it keeps its right for partial surrenders to be taxed under the more-favorable cost recovery rule rather than the less-favorable interest first rule usually applicable to annuities issued after 1982.

COMPLETE SURRENDER OF THE ANNUITY

Generally, if an annuity holder surrenders the annuity and receives the complete surrender value available under the contract, the holder must pay income tax on the difference between the amount he has received and his basis in the annuity. (In most instances, the annuity holder's basis will be equal to the amount of premiums paid into the annuity, but to be fully accurate in this calculation, the premiums paid figure must be reduced by any amounts previously received from the annuity that were properly excluded from the annuity holder's income.) In terms of the rules applicable to partial surrenders discussed above, a complete or full surrender of an annuity is taxed under the cost recovery rule.

For example: Assume that Mr. White owns an annuity with a cash surrender value of $50,000 and his basis, or the amount of premiums that he has paid into the contract, equals $20,000. Upon complete surrender of the annuity, Mr. White will pay income tax on $30,000. This figure is arrived at by subtracting the $20,000 basis in the annuity from the $50,000 amount received upon surrendering the contract.

EXCHANGES — SECTION 1035

On occasion, an annuity holder may wish to trade or exchange the annuity contract that he currently has for an annuity contract issued by another company. There are several reasons why an annuity holder would be interested in such an exchange, including the solvency of the current company, the interest rates currently being offered by various companies, and the desire for additional investment alternatives not offered under the current contract.

The Internal Revenue Code does provide for an exchange of one annuity contract for another, subject to certain requirements, in Code section 1035. If the requirements are met, the annuity holder may exchange one annuity contract for another without incurring any current income taxation. Despite the language of Code section 1035 which states that a permissible exchange is of "... an annuity contract for another annuity...," the Internal Revenue Service has concluded, in a private letter ruling, that the exchange of one annuity contract for two annuity contracts is a proper exchange under Section 1035.

Code section 1035 exchanges are generally available to nonqualified annuity contracts. Annuities used in Individual Retirement Annuities (IRAs) and Section 403(b) Tax Sheltered Annuities may be exchanged under certain circumstances but are generally subject to different rules.

Code section 1035 deals not only with the exchange of annuities but also with the exchange of life insurance policies. Generally, the section provides that the following exchanges may be made without current income taxation:

1. an annuity contract for another annuity contract;
2. a life insurance policy for an annuity contract;
3. an endowment contract for an annuity contract;
4. life insurance policy for another life insurance policy;
5. a life insurance policy for an endowment contract; and
6. an endowment contract for an endowment contract which will begin making payments no later than payments would have commenced under the old contract.

One type of exchange is not included in the list; the exchange of an annuity for a life insurance policy. This exchange is not permitted by Code section 1035. The reasoning behind this policy is assumed to be that allowing such an exchange would enable an annuity holder to transfer funds from the annuity, which incurs income tax on at least a portion of the benefits paid out under the contract, to a life insurance policy, which pays death benefits free of income tax. In other words, an annuity to insurance exchange would move from a tax-deferred item to a tax-free item. While the Internal Revenue Code is willing to allow policy holders to exchange policies, it is not willing to allow an exchange which will improve the income taxation of the benefits.

Whether the annuity contract received in exchange for a life insurance policy, an endowment contract, or fixed annuity contract is a variable annuity contract makes no difference. Such an exchange qualifies as a tax free exchange under Section 1035, whether the new contract is issued by the same company or a different company.

If an annuity is exchanged for another annuity, both contracts must be payable to the same person or persons. Otherwise, the exchange does not qualify as a tax free exchange under Section 1035. The Code defines an annuity for this purpose as a contract with an insurance company which may be payable during the life of the annuitant only in installments.

Within the confines of the Section 1035 exchange, the distinction between an "exchange" and a surrender and purchase is not always clear. If the annuity contracts are properly exchanged, there is no income tax due.

However, if one contract is surrendered and then a new contract is subsequently purchased there will more than likely be some income tax due as a result of the surrender of the old contract. Generally, where the annuity contract of one insurer is assigned, prior to maturity, to another insurer for a new contract of the second insurer, the transaction is considered an "exchange."

After a Section 1035 exchange takes place, the cost basis of the new annuity will be generally the same as the cost basis of the old annuity. (To the basis in the old annuity, future premiums paid must be added and any excludable amounts received after the exchange must be subtracted.)

This is true if no cash or property other than the new annuity contract is received in connection with the exchange. However, if cash or other property is received as a part of the exchange, any gain will be recognized to the extent of the cash or other property received.

Further, the existence of a loan against an annuity at the time of an exchange can affect the income tax outcome, although this situation does not arise often where annuities are concerned.

A question often asked when the exchange of one annuity contract for another is contemplated is whether the exchange will cause an annuity which is currently "grandfathered" for purposes of the taxation of withdrawals from the contract to lose this status. (Generally, withdrawals from annuities issued prior to August 14, 1982, are taxed under the cost recovery rule which states that the annuity holder may receive funds out of the contract on a tax free basis until he has received tax free amounts equal to his basis in the contract. Withdrawals from annuities issued after this date are taxed under the less-favorable interest first rule, as discussed earlier under the heading of "Taxation of Withdrawals.") In order to give effect to this grandfathering, a replacement contract obtained in a tax free exchange of annuity contracts will succeed to the status of the surrendered contract. In other words, if the old annuity contract was grandfathered, the new annuity contract received in a Section 1035 exchange will also be grandfathered.

Partial Tax-Free Exchanges of an Annuity

For years, the IRS resisted granting tax free status to partial exchanges of annuities, but now allows them so long as no distribution is made from either contract within 180 days of the exchange.

Tax-Free Exchanges by a Beneficiary

Recently, in a Private Letter Ruling, the IRS held that a beneficiary, already receiving benefits under an annuity payout option from a deferred annuity contract could exchange that contract for a new one, provided that certain restrictions were observed. The beneficiary could not add money to the new contract or assign it and could withdraw money from the new contract no less rapidly than she was withdrawing from the old contract. Insurance companies are divided on whether to permit this on the authority of only a Private Letter Ruling.

GIFT OF AN ANNUITY

It is not uncommon for an annuity holder to decide that she wishes to give the annuity to another person. Take, for example, Mrs. Tucker who purchased a deferred annuity as a funding vehicle for her daughter's college education but was happy to learn that her daughter had been awarded a full scholarship to college. Since the funds were ear-marked for the daughter's education but not needed for this purpose, Mrs. Tucker may decide to give these funds to the daughter.

The most obvious manner in which to transfer the funds is for Mrs. Tucker to surrender the annuity and give the cash to the daughter. However, this will result in an income tax cost to Mrs. Tucker equal to the amount received upon the surrender of the annuity less the amount she had contributed to the annuity over the years. Plus, this method has the further disadvantage of not providing the daughter with the benefit of the income tax deferral on the interest earned on the funds after she receives them that continuing the annuity would have offered.

A second alternative is for Mrs. Tucker to transfer ownership of the annuity contract to the daughter. After the gift, the contract will continue in existence with the daughter as owner. However, unlike the gift of some types of property, the gift of an annuity contract carries some immediate income tax consequences. Generally, an individual who makes a gift of an annuity contract that was issued after April 22, 1987 is treated as having received an amount equal to the cash surrender value of the contract at the time of the gift minus the annuity holder's investment in the annuity. To illustrate, assume that Mrs. Tucker had paid $1,000 each year into the college-expense annuity for 15 years. At the time she wishes to make a gift of the annuity to her daughter, the cash surrender value in the annuity contract is $22,000. Thus, at the time of the gift, Mrs. Tucker will have taxable income of $7,000. (This figure is arrived at by subtracting the $15,000 that Mrs. Tucker put into the annuity from the $22,000 cash surrender value.) Generally, this rule does not apply to a transfer between spouses or former spouses that is incident to a divorce. The treatment of the gift of an annuity issued before 1988 differs from the treatment of an annuity issued after this date, as discussed above.

If a person who has received a gift of an annuity contract does not surrender the contract but instead chooses to begin receiving annuity payments under the contract, the payments are taxed under the general annuity rules which call for the application of an exclusion ratio resulting in the taxation of a portion of each annuity payment. With respect to gifts of annuities issued after April 22, 1987, the person receiving the gift of the annuity takes as his basis in the contract the same basis as the person making the gift held at the time of the transfer.

SALE OF AN ANNUITY

The Seller

At times, the owner of an annuity contract may wish to sell the contract to another individual or perhaps even to a business entity. If such a sale takes place, the gain is taxed to the seller as ordinary income—not as capital gain. The amount of taxable gain resulting from the sale of an annuity is determined in the same way as upon surrender of a contract. In other words, gain is determined by subtracting the amount that the annuity owner had paid into the contract from the sale price.

However, where an annuity contract is sold after maturity, for purposes of determining the seller's gain, the cost basis of the contract (the amount the annuity owner has paid into the contract) must be reduced by the total of the portions of the annuity payments that have been received and were excluded from income. The adjusted basis cannot be reduced below zero.

Where an annuity contract is sold for less than its cost basis, apparently the seller realizes an ordinary loss.

As it relates to an annuity contract, a loss deduction can be claimed only if the loss is incurred in connection with the taxpayer's trade or business or in a transaction entered into for profit.

Generally, the purchase of a personal annuity contract is considered a transaction entered into for profit. Consequently, if a taxpayer sustains a loss upon surrender of an annuity contract, he may claim a deduction for the loss, regardless of whether he purchased the contract in connection with his trade or business or as a personal investment.

The amount of the loss is determined by subtracting the cash surrender value from the taxpayer's basis for the contract, which is generally equal to the amount he has paid into the annuity contract. The loss is an ordinary loss, not a capital one.

The Purchaser

If the purchaser of an annuity contract receives lifetime proceeds under the contract he is taxed in the same way as the original owner would have been taxed. His cost basis is, generally, the sales price that he paid for the contract plus any premiums he paid into the annuity after the purchase. If the contract is purchased after payments commence under a life income or installment option, a new exclusion ratio must be determined.

If the purchaser of an annuity is a corporation or other "non-natural" entity, the income tax deferral on the interest earned inside the annuity contract may be lost.

TAXATION OF ANNUITY BENEFIT PAYMENTS

The Basic Rule

The basic rule for the income taxation of payments received from an annuity contract is designed to return the purchaser's investment in equal tax-free amounts over the payment period. The balance of each payment received must be included in gross income. Each payment, therefore, is generally part nontaxable return of cost and part taxable income. Any excess interest or dividends added to the guaranteed payments is taxed as income in the year it is received.

The Exclusion Ratio

To determine what portion of the annuity payment is taxed and what portion is not, an exclusion ratio must be determined for the contract. The exclusion ratio may be expressed as a fraction or as a percentage and is arrived at by dividing the investment in the contract by the expected return. This exclusion ratio is applied to each annuity payment to find the portion of the payment that is excludable from gross income; the balance of the guaranteed annuity payment is includable in gross income for the year received.

To illustrate an exclusion ratio, assume that Mr. Baker, age 58, begins to receive annuity payments which will extend over his life time. At the time the payments commence, Mr. Baker has paid $100,000 into the annuity contract. Of the $700 payment that Mr. Baker will receive each month, 54% ($378 for the month or $4,536 for the year) must be included in his income for the year. The remaining 46% of the payment ($322 for the month or $3,864 for the year) not taxable.

The 46% exclusion ratio is arrived at by taking the investment in the contract of $100,000 and dividing by the expected return of $217,560. (The expected return amount of $217,560 is calculated by multiplying the $700 monthly payment by 12 to arrive at a yearly amount of $8,400 and then multiplying this amount by Mr. Baker's life expectancy of 25.9 years.)

In the unusual instance where the investment in the contract is greater than the annuity holder's expected return, the full amount of each payment is received tax-free.

The number of months or years for which the exclusion ratio applies is governed by the "annuity starting date," which is the first day of the first period for which an annuity payment is received. If the annuity starting date is after December 31, 1986, the exclusion ratio applies to payments received until the investment in the contract is fully recovered. Payments received after this point are fully includable in income. Since the annuity starting date is after 1986, Mr. Baker will no longer be able to exclude 46% of the monthly annuity payment from income beginning in November of 2023.

If, on the other hand, the annuity starting date was before January 1, 1987, the exclusion ratio applies to all payments received throughout the entire payment period, even if the annuitant has recovered his investment. Thus, it is possible for a long-lived annuitant to receive tax-free amounts which total more than he put into the annuity contract.

The Investment in the Contract

Generally speaking, the investment in the contract is the gross premium cost or other consideration paid for the annuity contract. To be fully accurate in this calculation the gross premium cost must be reduced by any amounts previously received from the annuity to the extent that these amounts were properly excluded from the annuity holder's income.

In the case of a participating annuity contract, dividends must be taken into account for purposes of calculating the investment in the contract. If dividends have been received in cash or used to reduce premiums, the total amount of these dividends received or credited before the annuity payments commenced must be subtracted from gross premiums to the extent the dividends were excluded from the annuity holder's income. But if excludable dividends have been left on deposit with the insurance company to accumulate at interest, and the dividends and interest are used to produce larger annuity payments, such dividends are not subtracted from gross premiums but are considered part of the cost of the larger payments. In this situation, gross premiums plus accumulated interest equal the cost of the contract.

It is helpful to remember that there are different rules that apply in computing the investment in the contract with respect to employee annuities such as IRAs, TSAs, and qualified retirement plans.

If the annuity is a life annuity with a refund or period-certain guarantee, a special adjustment must be made to the investment in the contract. The value of the refund or period-certain guarantee, as determined under certain rules, must be subtracted from the investment in the contract. It is this adjusted investment in the contract that is used in the exclusion ratio.

The Expected Return

The expected return from an annuity contract, as discussed above, is the figure into which the investment in the contract is divided when calculating the annuity's exclusion ratio. Generally speaking, expected return is the total amount that the annuitant (or annuitants) can expect to receive under the contract.

More specifically, if payments are for a fixed period or a fixed amount with no life expectancy involved, expected return is the sum of the guaranteed payments.

If payments are to continue for a life or lives, expected return is arrived at by multiplying the sum of one year's annuity payments by the life expectancy of the measuring life or lives. The life expectancy multiple or multiples must be taken from the Annuity Tables set forth by the IRS.

Assume that 50-year-old male will begin receiving annuity payments over his life time from an annuity into which he has paid $50,000. He will receive monthly annuity payments of $300 or $3,600 annually. Each year he will exclude from income $1,512, or 42%, and include in income the remaining $2,088, or 58%. The exclusion ratio was arrived at by dividing the investment in the contract of $50,000 by the expected return of $119,160. The expected return was calculated by taking the monthly annuity payment of $300 and multiplying it by 12 months to arrive at $3,600 and then multiplying this amount by the annuitant's life expectancy.

Taxation of Variable Annuity Benefit Payments

Variable annuities are similar to fixed annuities in some respects and yet different in other respects. The same is true regarding the taxation of fixed and variable annuities. In some respects taxation is the same while in other instances the taxation differs.

One area where fixed and variable annuities are taxed similarly is the deferral of income tax on the interest earned inside the annuity. Generally, an annuity owner who is a natural person will pay no income tax until he either surrenders the annuity for cash or begins to receive an income under the contract.

However, in order to receive this deferral of income tax, a variable annuity must meet one additional requirement. Beginning on January 1, 1984, a variable annuity contract will not be treated as an annuity and taxed as such unless the underlying investments of the segregated asset account are "adequately diversified," according to regulations prescribed by the Internal Revenue Service.

Both fixed dollar and variable annuity payments are subject to the same basic tax rule: a fixed portion of each annuity payment is excludable from gross income as a tax-free recovery of the purchaser's investment, and the balance is taxable as ordinary income. However, the rules for these types of annuities differ in that with a variable annuity the excludable portion is not determined by calculating an "exclusion ratio" as it is for a fixed dollar annuity. Since the expected return under a variable annuity is unknown, it is deemed to be equal to the investment in the contract. Thus, the excludable portion is determined by dividing the investment in the contract by the number of years over which it is anticipated the annuity will be paid.

If payments are to be made for a fixed number of years without regard to life expectancy, the divisor is the fixed number of years. If payments are to be made for a single life, the divisor is the appropriate life expectancy multiple from Table I or Table V, whichever is applicable (depending on when the investment in the contract was made).

Remember that, as discussed earlier, the amount determined using the exclusion ratio may be excluded from gross income each year for as long as the payments are received if the annuity payments began before January 1, 1987. If the annuity payments begin after 1986, the amount determined may be excluded from gross income only until the investment in the contract is recovered.

There is one other income tax "quirk" that applies to variable annuities, but not fixed annuities, purchased some years back. If the owner of a variable annuity contract acquired prior to October 21, 1979, dies before the annuity payments begin, the contract acquires a new cost basis rather than retaining as its cost basis the amount which has been paid into the annuity. The basis of the contract in the hands of the beneficiary will be the value of the contract at the date of the annuitant's death.

Therefore, this "quirk" in the law provides a possible income tax savings in that if the annuity's basis equals the amount received by the beneficiary there will be no income taxable gain and the appreciation in the value of the contract while owned by the deceased will escape income tax entirely. However, the Internal Revenue Service has indicated its general opinion that if a variable annuity contract purchased before October 21, 1979 is exchanged, via Code section 1035, for another variable annuity contract issued after October 20, 1979 and the annuity owner dies before the annuity payments begin, the beneficiary will not be entitled to this "step-up" in basis.

DEATH OF THE ANNUITY OWNER

An annuity is usually purchased on the assumption that the annuity owner will live long enough for the annuitant to begin receiving annuity payments. In reality, of course, this does not always happen. When the owner dies before the entire interest in the contract has been paid out certain distributions from the annuity must be made. These rules are intended to prevent deferral of income tax on the gain in the annuity for an indefinite period of time through successive ownership of the annuity.

The Internal Revenue Code mandates that an annuity issued after January 18, 1985, will not be treated as an annuity contract and, thus, receive the income tax deferral associated with an annuity unless the contract provides two items. First, the annuity must provide that if any owner dies after the annuity has begun making annuity payments (i.e., after the annuity starting date) but before the entire interest in the contract has been distributed, the remaining portion must be distributed at least as rapidly as under the method of distribution being used at the owner's death. Second, the annuity must provide that if the owner dies before the annuity payments have started, the entire interest in the contract must be distributed within the five years following the owner's death. In the case of joint owners of an annuity issued after April 22, 1987, these distribution requirements are applied at the first death.

For purposes of meeting these distribution requirements, if any portion of the owner's interest is to be distributed to a designated beneficiary over the beneficiary's life (or over a period not extending beyond the life expectancy of the beneficiary) and the distribution begins within one year after the owner's death, that portion will be treated as distributed on the day such distribution begins.

For example assume that Mr. Robins, age 50, buys an annuity contract and is the owner. He names his son, Mr. Robins, Jr., age 25, as the annuitant, with annuity payments to begin when his son becomes age 45. The father dies at age 58 and the son (now age 33) becomes the new owner of the contract. Under the provisions discussed above, there must be a distribution of the entire interest in the contract within five years of the father's death or there must be annuitization of the contract within one year of such date.

If the designated beneficiary (that is, the person who becomes the new owner) is the surviving spouse of the owner, then the distribution requirements are applied by treating the spouse as the owner. In effect, this allows a surviving spouse to "step into the shoes" of the deceased spouse and carry the annuity along without any change. For example: Assume that Mr. Smith purchased a single premium deferred annuity five years prior to his death, naming himself as owner and annuitant and his wife, Mrs. Smith, as the designated beneficiary. He had not yet started to receive payments from the annuity contract at his death. Since Mrs. Smith would be treated as the annuity contact owner upon his death, the distribution requirements would allow her to continue the annuity in its accumulation phase for the time being.

For the purpose of these distribution requirements which take effect upon the death of the annuity owner, some provision must be made when the annuity owner is an entity such as a trust or corporation. The Internal Revenue Code provides that where the owner of a contract issued after April 22, 1987, is a corporation or other non-natural person, the primary annuitant will be treated as the owner of the contract. The primary annuitant is the individual whose life is of primary importance in affecting the timing or amount of the payout under the contract (e.g., the measuring life). For purposes of these distribution requirements, a change in the primary annuitant of such a contract is treated as the death of the owner.

If an annuity contract which is issued after January 18, 1985 is received in exchange for one issued prior to that date it will be considered a new contract and, thus, subject to these distribution requirements.

DEATH OF THE ANNUITANT

Often it is the same person who is named as both the owner and the annuitant of an annuity contract. Thus, when the annuitant dies, the owner also dies and the annuity is subject to the distribution requirements discussed above. However, there are times when one person is named as the annuity contract owner and another individual is named as the annuitant. One example of this is grandparents who buy an annuity for a grandchild naming one of the grandparents as owner of the contract and the grandchild as the annuitant.

There are two kinds of deferred annuity contracts in terms of when death benefits must be payable:

"Annuitant-Driven" contracts pay the death benefit to the beneficiary upon the death of the annuitant. Not all deferred annuity contracts are of this type.

"Non-Annuitant Driven" ("Owner-Driven") contracts pay a death benefit to the beneficiary upon the death of the owner.

All contracts issued since January 18, 1985 must pay out upon the death of the owner. Some contracts ("Annuitant-Driven") will also pay out upon the death of the annuitant. Obviously, this distinction is unimportant when the annuitant and owner are the same individual, but when the annuitant and owner are different parties and the contract is "annuitant-driven", the death of either the annuitant or owner will cause payout to the beneficiary. The amount of that death benefit may be different, depending upon who dies first. If the annuitant-driven contract provides for a Guaranteed Minimum Death Benefit, that benefit is generally payable upon the death of the annuitant, but as the death of the owner must also trigger payout, the death benefit upon the owner's death is generally the contract's cash value.

The death benefit under an annuity contract is not excludable from income under Code section 101(a) as life insurance proceeds payable by reason of insured's death. The gain in an annuity contract is measured by subtracting the total premiums from the death benefit received. (Aggregate dividends and any other amounts that have been received under the contract which were excludable from gross income must be added to the death benefit received amount as a part of this calculation.)

Thus, continuing with the grandparents/grandchild example mentioned earlier, if the grandchild dies and the grandparent is still living, a death benefit amount will be paid to the grandparent*, if the contract is annuitant-driven.* If it is not, then, at the grandchild's death, the grandparent can simply name a new annuitant.. If the death benefit paid equals $25,000 and the grandparents have paid $20,000 into the annuity, then the gain of $5,000 must be included in the grandparent's income for the year.

There is one election open to the annuity owner at the time of the annuitant's death which may help to minimize the income tax consequences of the annuitant's death. The beneficiary of the death benefit will not be taxed on the gain in the year of death if he elects, within 60 days after the annuitant's death, to apply the death benefit under a life income or installment option. The periodic payments will then be taxable to the beneficiary under the regular annuity rules.

Another question that arises in relationship to an annuity when investment results have not met expectations is whether there is a deductible loss sustained under a straight life annuity if the annuitant dies before the total annuity payments received equal the annuitant's cost. If the annuity contract began making annuity payments before July 2, 1986, there is no deductible loss since the annuitant has received all that the contract called for. The result is the same for one who purchases an annuity on the life of another person who dies prematurely. If the annuity payments began after July 1, 1986, a deduction may be taken on the individual's final income tax return for the unrecovered investment in the contract.