Taxation of Annuities

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One feature many annuity salespersons extol is the tax-deferred nature of an annuity. While it is true that annuities offer some distinct tax advantages, it is also true that they contain tax pitfalls for the unwary. The tax code regarding annuities is very complicated and, in many instances, not entirely clear. Many factors affect the ultimate outcome of an investment in annuities: ownership, beneficiary designations, distributions requirements, etc. It is easy for an advisor to make mistakes that could have serious consequences for both the client and advisor. Therefore it is very important that financial advisors be aware of the tax regulations, if for no other reason than to be aware of the limitations of their own understanding — and refer clients to expert tax advice when conditions warrant a referral.

This first part of this chapter will focus on the tax treatment of so-called non-qualified annuities, that is annuities purchased with after-tax dollars. Qualified annuities — annuities purchased in qualified retirement plans and IRAs — are subject to an entirely different set of tax rules. Qualified contracts are explored at the end of this chapter. It is critical to make this distinction between qualified and non-qualified annuities. Non-qualified annuities represent the investment of after-tax dollars, which grows in a tax-deferred setting. Monies eventually received from a non-qualified annuity will be treated as either tax-free return of principal and taxable growth or earnings. Regardless of the source of that growth (interest in the case of fixed annuities, stock market gains in the case of variable contract), the growth portion of the contract will always be taxed as ordinary income, never as capital gains.

As we learned in Chapter 1, there are two distinct periods in an annuity contract: the accumulation phase and the annuity phase. In the accumulation phase, the contractholder retains control over the contract's cash value and may choose to surrender the contract, make a partial withdrawal, exchange the contract for another annuity, and in the case of variable annuities, redirect the investments from one subaccount to another. The contractholder may also choose to annuitize the contract. Once the contract enters the annuity phase, however, the contractholder loses control. The contract is converted into a vehicle that simply will distribute annuity payments using the payout method selected by the contractholder. All immediate annuities pay only annuity payments (there is no accumulation period). Deferred annuities allow for both withdrawals prior annuitization and annuity payments, if the contractholder chooses to annuitize the account. The tax code recognizes these two periods — and different tax treatments apply to monies taken from the contract during the accumulation period versus annuity payments received during the annuity phase. The tax code refers to the latter payments as "amounts received as an annuity" — while monies taken out during the accumulation phase are cleverly referred to as "amounts not received as an annuity".

Income Taxation

Income Tax Treatment During the Owner's Lifetime

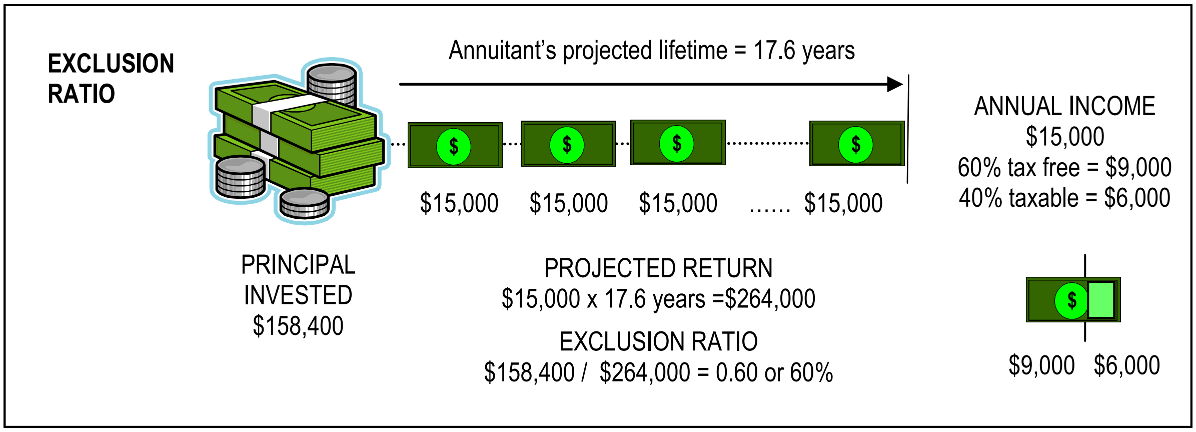
It is important to note that regardless of who receives the funds, the contractholder will be taxed if the monies are disbursed from the contract while the contractholder is alive. In the great majority of cases, the contractholder will be the person receiving the funds — either through lifetime withdrawals or annuity payments. But in situations where the monies are paid to a third party, the contractholder will be taxed nonetheless. For example, a father buys an immediate annuity and directs the annuity payments to be paid to his daughter. The IRS will tax the father for the payments received by the daughter.

Amounts Received as an Annuity

Under the tax code, an annuity is a series of payments that include the liquidation of the principal sum. Lifetime annuities, as well as annuities for a fixed period, meet this definition (as would winnings of a lottery paid over time, or a structured settlement of a law suit). The basic premise of the tax code is that each periodic annuity payment is part interest and part return of principal. The interest or earnings portion of each payment is taxable as "ordinary income", while the portion representing the return of principal is tax-free (in tax talk, it is "excluded from tax").

In order to determine which portion of each annuity payment is taxable — or more correctly stated which portion of the payment is tax-free — the IRS has established an "exclusion ratio". This ratio is calculated differently depending on whether the annuity is a fixed or variable contract. In the case of fixed annuities, the exclusion ratio compares the total investment in the contract with the expected return. The total investment equals any premiums paid by the contractholder to the annuity company, less any withdrawals or dividends received by the contractholder. The total investment is adjusted if the payout method includes any refund features, such as "lifetime with 10 year period certain", or "joint life with one-half survivor". If the payout method contains protection for a beneficiary, the total investment will be adjusted (reduced). The expected return is based on the annuitant's remaining life expectancy (survivorship factor). While each company may base its payout schedules on its own survivorship factors, the IRS requires taxpayers to calculate the exclusion ratio using IRS life expectancy tables.

> As a simple example, Harry Johnson invested $158,400 in an immediate, straight life, fixed annuity in November 2007 that will pay him $1,250 per month ($15,000 per year). Harry is 68 years old. According to the IRS life expectancy tables, Harry is projected to live another 17.6 years and collect a total of $264,000 (17.6 x $15,000). His initial investment represents 60% of his total return. ($158,400 / $264,000 = 0.60 or 60%). Put another way, 60% of the checks he will receive represent return of his investment, which is excluded from taxation. Harry's exclusion ratio is 60%. Each year Harry will receive annuity payments of $15,000. Of this, 60% is tax-free ($9,000) and the remaining 40% ($6,000) is taxable each year as ordinary income. At the end of 17.6 years, Harry will have received back his entire investment (17.6 x $9,000 = $158,400).



What if Harry lives longer than the 17.6 years the IRS assumed he'd live? Prior to 1987, the tax rules stated that Harry could continue to apply the exclusion ratio, even though he had already recouped his entire investment. Those rules remain in effect if the annuity payments started prior to January 1, 1987. If the annuity period started after that date, new rules apply. More recent contracts may apply the exclusion ratio only until the entire principal is returned (that is, up to the projected life expectancy); thereafter, the exclusion ratio no longer applies and the entire annuity payment is taxable.

Keep in mind that this was a very simple example. Harry selected a straight life annuity payout, so there was no refund feature to adjust for. The annuity payments started immediately, so there was no chance for Harry to make a withdrawal, which would also call for adjustments. The IRS has a number of life expectancy tables — some are gender specific, others are unisex. Adjustments are made to the tables if the annuity payments are paid quarterly or annually, instead of monthly. Different tables apply depending on whether the investor added funds to the contract after June 30, 1986. Needless to say, calculating the proper amount of the annuity payment to include on one's tax return can be complicated — and may fall outside the realm of most advisors' expertise. Financial advisors should, however, be aware of the basic premise of an exclusion ratio and have a rough idea of how it is calculated.

In the case of variable annuities, the expected return from the contract cannot be accurately measured — it is, after all, based on the varying future value of a fixed number of annuity units. What can be projected accurately is the annuitant's remaining life expectancy. Taxpayers who own variable annuities calculate their annual exclusion factor by dividing the total investment in the contract by the life expectancy found in the IRS tables. Just as with the fixed annuities, this represents a return of principal spread evenly over the expected remaining life of the annuitant. Any annual annuity payments received in excess of this amount will be taxable. It is possible that in some years the investment results of the separate account may not generate enough to pay out the exclusion amount. In which case, the entire annuity payment will be received tax-free. If the annuitant lives as long as the projected life expectancy, he or she will have received back all of their investment. Depending on when the variable annuity payments started, future payments may or may not be excluded from taxation (using the same rules and dates that applied to fixed annuities above). While calculated differently, the exclusion ratio on a variable annuity performs the same function as it does for fixed annuities — it is a way to account for the tax-free return of principal in a series of periodic payments.

Amounts Not Received as an Annuity

Annuity payments are not the only way a contractholder may obtain funds from the contract. Contractholders can exercise control over a deferred annuity contract's value up until the time it is annuitized (i.e., during the accumulation phase). This is true of both fixed and variable annuities. The contractholder may surrender the entire contract, take a partial withdrawal, or exchange the contract for another. Each of these has a tax consequence.

Surrender. By surrendering the contract, the owner is simply "cashing in" his investment for a lump sum. The total investment in the contract is calculated as before, i.e., total premiums paid in to the contract less any dividends, withdrawals, or loans taken out. Return of principal is tax-free; any amount received in excess of the principal amount is taxable as ordinary income in the year it is received.

Partial withdrawal. Implicit in the discussion so far is that earnings in the contract grow tax-deferred; taxes are payable when the earnings portion of the account's value is taken from the contract. In the case of annuity payments, a portion of the earnings is released with each payment. In the case of surrender, the entire earnings portion is released in a lump sum. But what if only part of the account's value is released? Is the portion released considered taxable earnings, tax-free principal or a combination of the two? The answer to those questions depends on when the annuity contract was issued. For contracts entered into before August 14, 1982, the IRS assumes that the first monies withdrawn from the contract represent the first monies in the contract. (This is sometimes called the first-in, first-out method or FIFO). The first monies in the contract are the premiums the contractholder paid. The first sums withdrawn will represent the return of principal. Only after all of the tax-free principal is withdrawn will the contractholder start to receive taxable income.

> For example, an investor contributed $60,000 to a deferred variable annuity in 1980. In 2004, when the contract is worth $195,000, the contractholder withdraws $40,000. That withdrawal is tax-free return of principal. The withdrawal does reduce the owner's investment in the contract (his "cost basis") to $20,000. In 2005, the contractholder withdraws another $30,000. This represents the last $20,000 of his original investment, and $10,000 of taxable earnings. All future withdrawals will be fully taxable since he has already withdrawn all tax-free principal from the account. The opposite is true for contracts issued after August 13, 1982. The IRS applies a LIFO or last-in, first-out accounting method to these newer contracts. The last monies added to the contract's value (earnings) are the first to be withdrawn. Had the owner in the example bought the annuity in 1984, the 2004 and 2005 withdrawals would be fully taxable earnings. Only the last $60,000 taken from the account's value would be considered tax-free return of principal.

(In the mid-1980's, some contractholders sought ways to minimize the adverse nature of this change from FIFO to LIFO accounting. Instead of purchasing one contract, as in the above example, they would purchase a number of smaller contracts. Then, if part of the investment was needed in the future, they would surrender one of the contracts — this would allow part of the surrender to be treated as tax-free return of principal. The IRS deemed this an abusive practice. Today, all purchases of annuities within a calendar year from the same annuity company are treated as a single contract for tax purposes. Although, contracts purchased through different annuity companies will be treated separately.)

The FIFO/LIFO rules that apply to partial withdrawals also apply to other distributions during the accumulation phase, such as dividend payments, loans taken from the account (if loans are allowed by the contract's terms), or when the account is assigned as collateral for a loan. While loans are not usually allowed in most non-qualified annuity contracts, advisors should be aware that simply pledging the contract as collateral for a loan might trigger an adverse tax consequence for the contractholder.

Exchanges. Section 1035 of the Internal Revenue Code allows for some tax-free exchanges of life insurance products. Contractholders can exchange an existing annuity contract for another annuity contract. Life insurance policyholders can exchange their policy for another policy or an annuity contract. However, a tax-free exchange from an annuity contract to a life insurance policy is ***not*** permitted under Section 1035. There are many reasons to exchange annuity contracts: to switch from a fixed to a variable contract, or vice versa; to upgrade to a higher-quality annuity company; to consolidate multiple annuities into one contract; to obtain less-restrictive contract terms; to obtain a contract with more favorable annuity payout factors or contract guarantees; etc.

When contractholders engage in a "**1035 exchange**", they simply carry their existing cost basis (investment in the contract) to the new annuity. Future tax treatment will be based on that original investment. Using the above example one more time: in 1980, a contractholder invested $60,000 in a deferred variable annuity that has grown to a cash value of $195,000. He now wants to exchange that contract for a $195,000 fixed annuity. Under Section 1035, there will be no tax consequence for the exchange, and his original $60,000 cost basis will apply to the new contract. Also note that the LIFO/FIFO nature of the existing contract is retained. In this case, the existing contract is subject to the more-favorable FIFO treatment (it was issued before 1982), and that treatment is applied to the new contract, too.

It is important to note that Section 1035 allows for additional investment to be made in conjunction with the exchange. The contractholder in the above example could exchange the variable contract plus another $55,000 for a $250,000 fixed annuity. The new cost basis would be $115,000 (the original $60,000 + the additional $55,000). The rules are less clear when a partial exchange is made. Suppose the contractholder exchanged the $195,000 variable contract for a $150,000 fixed annuity plus $45,000 in cash. In the past, the IRS fought taxpayers who would partially surrender a contract in exchange for a smaller contract, plus cash. The IRS feared this allowed the creation of small contracts as an abusive way to avoid the tax consequences of the LIFO accounting method (similar to the multiple contract concept discussed above). The IRS lost its arguments in tax court and now allows for partial 1035 exchanges, provided the taxpayer does not intend to surrender the new, smaller contract within two years of the exchange. The cash received from the partial exchange is called the "boot" and is usually taxable.

Section 1035 exchanges are very common events. Most financial advisors should become comfortable in understanding the process as it relates to simple this-for-that exchanges, and be able to explain the ramifications of those exchanges to clients. In the case of more complicated exchanges involving multiple contracts, unequal amounts, loan payoffs, etc., many financial advisors may want to consult an expert in the field before making a recommendation to their clients.

Penalty for Premature Distributions

When Congress granted the benefit of tax deferral to annuities it intended the contracts to be used as a retirement plan. To discourage the use of deferred annuities as a short-term investment vehicle for young people, Congress imposed a 10% penalty on "premature distributions". This 10% penalty is similar to the penalty imposed on early withdrawals from qualified retirement plans.

Generally speaking, the 10% penalty applies if withdrawals are taken from a non-qualified annuity prior to age 59½, but there are exceptions to this general rule. Withdrawals may be taken from a deferred annuity prior to age 59½ without penalty if:

- the owner dies,
- the owner becomes disabled,
- a series of substantially equal payments are scheduled for the owner's lifetime (or joint life expectancy of the owner and beneficiary), or
- the contract was issued before August 14, 1982.

Note that the 10% penalty generally applies to deferred annuities only. This penalty does not apply to annuity payments received from immediate annuities that are purchased outright. However, if a contractholder exchanges a deferred annuity for an immediate contract under Section 1035, those annuity payments are subject to the 10% penalty, unless one of the exceptions listed above applies. If the contractholder selects a lifetime payout method for the exchanged immediate annuity (as opposed to a payout over a specified period), she will receive substantially equal payments for a lifetime and thus avoid the 10% penalty using that exception.

The 10% penalty applies only to the taxable portion of a premature distribution. In other words, the penalty does not apply to tax-free return of principal. (Note: This is different than the penalty for premature withdrawals from qualified retirement plans, which applies to the entire withdrawal, not just the taxable earnings portion.)

Eligibility for Tax Deferral

Tax-deferred growth is one of the key selling points of an annuity — but this feature is not available to all contractholders. Only "natural persons" enjoy a tax deferral. A "natural person" is a human being. If a corporation, partnership, trust, estate or other organization owns the annuity, it will not receive the same favorable tax treatment enjoyed by "natural persons". For these organizations, the growth in the account is taxable each year as it is earned. The annual earnings within the annuity are taxed as ordinary income each year. There are a couple of exceptions to this general rule:

- estates that receive an annuity upon death,
- annuities held in a qualified retirement plan,
- annuities purchased to replace payments from a terminated qualified retirement plan,
- single premium immediate lifetime annuities that pay out at least annually, or
- trusts or other entities that act simply as an agent for a natural person.

This last exception is an important one for clients who set up trusts. An annuity held in a trust may enjoy tax-deferred status if the trust simply holds the annuity as an agent for an individual. In many revocable living (*inter vivos*) trusts, the trust is simply a surrogate for the trust grantor during his or her life. There should be no problem with the tax status of annuities held in such trusts. Where the trust has another purpose, however, there may be adverse tax consequences if the trust owns an annuity. The same might be said for family limited partnerships, limited liability corporations, etc. — as these organizations usually involve more than simply holding assets for an individual. Before recommending the purchase of an annuity within one of these entities, advisors should seek expert tax advice.

Transfers of Annuity Ownership

While a contractholder may exchange one annuity for another tax-free under Section 1035, transfers of an annuity's ownership to another person may raise serious income tax and/or gift tax consequences. As we'll learn in Chapter 3, there is a market for existing annuities. If an annuity owner exchanges ownership for "full and adequate consideration", the transfer is treated as a sale. This is a murky area of tax law. Presumably, one would only sell the contract, rather than surrender it, if one could obtain more from the sale than its surrender value. For example, a contractholder has a cost basis of $60,000 in a contract that has an $80,000 surrender value — and due to favorable contract provisions, a buyer is willing to pay $85,000 for the contract. If the contractholder sells the contract for $85,000, he should recognize $20,000 in ordinary income (just as he would had he surrendered the contract for $80,000) and an additional capital gain of $5,000 from the sale. If sold for less than its cost basis, the seller apparently realizes an ordinary loss (A contractholder might do this if the sale price is more than could be obtained by surrendering the contract after taking surrender charges into account.) By the way, if the surrender value is less than the owner's cost basis, surrender will result in an ordinary loss in the year of sale.

For contractholders who transfer an annuity for "less than full consideration" — the transfer is considered a gift, not a sale . Contractholders must treat the excess of the surrender value over the cost basis as ordinary income. If the annuity was issued after April 22, 1987, the income will be taxed in the year of the donation (if issued before that date, that income will be taxed when the donee surrenders the annuity, or otherwise receives the contract value.) The recipient (donee) of the annuity will retain the donor's original cost basis (adjusted by adding any gift tax the donor paid on the gift, plus any consideration the donee paid to the donor). This tax treatment does not apply to gifts between spouses, transfers to ex-spouses due to divorce, or a gift from a trust to its beneficiary. Obviously, gifts of annuities can be a complicated affair for tax purposes.

Transfers to Trusts

Sometimes a contractholder may wish to transfer ownership of his or her annuity to a trust. These may or may not be subject to income and gift taxes, depending on whether the trust is revocable or irrevocable, and whether the trust is a "grantor trust" or a "nongrantor trust".

A grantor trust is one in which the grantor is a beneficiary of the trust (directly or indirectly). If the grantor or the grantor's spouse benefits from the trust, such as receiving income payments, it is a grantor trust. If the grantor or spouse exercises control over the trust assets, it is a grantor trust. If the trust distributes income to third parties to cover obligations of the grantor, such as to pay off a debt or make child-support payments, it is a grantor trust. Generally speaking, the IRS will view grantor trusts as an extension of the grantor, not as a separate entity. This means that income from the trust will be taxable on the grantor's tax return as though the grantor earned it. If the trust is a non-grantor trust, the IRS will tax it as a separate entity. Income earned in a nongrantor trust is subject to special tax rates (which may be more or less than the rate the grantor pays on his personal income tax return) .

The IRS imposes a gift tax on "completed gifts" of a "present interest". A present interest means that the recipient can enjoy the gift today, and a completed gift is one with no strings attached. If the donor can reclaim the gift, it is not "completed".

This is a brief summary of very complicated tax law. Individuals who would like to transfer an annuity into a trust should obtain expert tax advice. Generally speaking, advisors should be aware that:

transfers to the individual's revocable living trust are not a taxable for income tax purposes, since the trust falls under the "grantor trust" rules (the grantor remains in control of the trust) — and the transfer is not subject to gift taxes; the grantor can revoke the trust, so the gift is not considered a "completed gift"

transfers to the individual's irrevocable grantor trust are not taxable for income tax purposes (again, due to the grantor trust rules) — but the transfer is subject to gift taxes as the gift is irrevocably completed.

transfers to an individual's irrevocable non-grantor trust will trigger possible income taxation, as described earlier, and full value of the annuity is considered a taxable gift. In addition, the non-grantor trust will not qualify as an "agent of a natural person", so the trust loses the contract's tax deferred status — the trust will have to include each year's growth as ordinary income on the trust tax return.

Sometimes an annuity owner will want to give an annuity to a charity — this usually occurs when the contract contains a large amount of tax-deferred earnings. Given the complex tax treatment of gifted annuities, it is usually better for the annuity owner to surrender the contract and donate the cash proceeds to the charity instead.

Tax Treatment Upon Death

The tax treatment of an annuity's death and survivor benefits is can be quite complicated. Upon a contractholder's (or annuitant's) death, the annuity may be subject to both income taxation and estate taxes. There are different tax treatments depending on who the beneficiary is, whether the owner annuitized the account, the payout method selected by the beneficiary, etc. We'll start with estate taxes first, and then look at income tax treatment.

Estate Taxation

The federal estate tax is a highly progressive tax (there are many tax brackets, each with a higher rate) with rates as high as 55% for very large estates. Upon death, the IRS will include all property over which the decedent had control at the time of death. While revocable trusts and other estate planning vehicles are useful for avoiding the cost and inconvenience of probate — these planning tools will not avoid estate taxes. If the decedent exercised control or held "incidents of ownership" over property when he or she died, the estate tax will apply. To summarize a very complex system, the value of all assets controlled by the decedent at the time of death will be totaled up, certain deductions will be subtracted (the two most generous deductions are for any property left to a surviving spouse or charity), and the appropriate tax rate is applied to the balance. Each taxpayer is then granted a "unified credit" to offset the tentative tax. Any tax in excess of the unified credit is due and payable nine months after the decedent's death. The unified credit will fully shelter relatively modest estates from this tax. So for many clients, estate taxation may not be an important issue. For larger estates, however, estate taxes can impose a large burden. Not only can the tax bill be quite large, but the short timeframe to pay the taxes may also place the estate and survivors in a "liquidity squeeze".

This discussion will focus on the estate tax treatment of annuities. As was the case during the contractholder's lifetime, the IRS makes a critical distinction between annuities held by a decedent that are in the accumulation phase and those that have entered the annuity (payout) phase.

If the annuity is in the accumulation phase, i.e., the decedent has not yet annuitized the contract; the full death benefit guaranteed by the contract (including any enhanced death benefits) will be included in the taxable estate. For fixed annuities, this is usually the premiums invested plus the guaranteed rate of return accumulated until the time of death. For variable annuities, this is generally the greater of the investment in the contract or the contract's cash value at the time of death (although the enhanced death benefit rider may provide for more generous benefits.)

If the annuity has been annuitized, the value of any remaining annuity payments will be included in the taxable estate:

- if the contractholder selected a straight life payout method, the annuity payments stop upon his death and there is nothing to include in the estate
- if the contractholder selected an annuity with contingent payments for a beneficiary, the value of any remaining payments to the beneficiary will be included in the estate
- if the contractholder was receiving a joint and survivor payout, the estate must include the

value of the survivor's annuity payments

The value of the remaining payments is the amount the same insurance company would charge for an annuity providing the same projected payments from the time of the decedent's death. Let's take a look at a few examples.

Example 1: Dorothy owned a fixed annuity contract issued by ABC Annuity Company at the time of her death. When she annuitized the contract twelve years ago, she selected a life annuity with 15-year period certain. The annuity has been paying her $1,200 per month. Since the contract guarantees payments for a minimum of 15 years, this leaves three years of payments to be made to her son, Ron, her designated beneficiary. Dorothy's executor will contact ABC to find the current price to purchase a fixed period annuity that will pay $1,200 for three years. That value will be included in Dorothy's estate for tax purposes.

Assume instead, that Dorothy annuitized this contract 18 years ago. At the time of her death she had outlived the 15-year period certain. Upon her death, the payments stop — there is nothing to be paid to Ron, so there is nothing to include in her estate.

Example 2: Ed purchased an annuity from XYZ Annuity Company years ago. Two years ago he annuitized the account selecting a lifetime with cash refund payout option, naming his daughter Cindy as beneficiary. At the time of his death, there was $40,000 principal remaining in the contract. XYZ will pay Cindy the $40,000 and Ed's executor will include that amount on Ed's estate tax return.

Example 3: Geraldine and Miles, a married couple, own a joint and two-thirds survivor annuity issued by Acme Annuities. The annuity was paying $1,500 per month at the time of Miles' death, when Geraldine was 78 years old. After Miles' death, Acme will reduce the survivor annuity payments to 2/3rds of the joint payments; Geraldine will receive $1,000 per month for the rest of her life. Miles' executor will contact Acme to find out what it would cost to provide a 78-year old woman with a $1,000 per month lifetime annuity. That value will be included in the tally of taxable assets in Miles' estate.

Since Geraldine and Miles were married, the benefits payable to Geraldine represent property passing to a surviving spouse. The estate will be able to use the unlimited marital deduction to avoid taxation of these annuity benefits (the value of the benefits will be listed on the estate tax form, along with an offsetting marital deduction). Assume instead that Geraldine and Miles were cohabitating “without benefit of clergy”. In this case, Miles' estate would include the value of the remaining annuity payments, but there would be no marital deduction to offset that inclusion. The same would apply if this were Gerald and Miles, a same-sex couple.

Please note that the annuity's remaining value is determined at the time of death. The company's interest rate assumption or mortality tables may have changed since the annuity was originally issued — so the executor needs to obtain a current valuation as of the date of death.

Income Taxation of Death Benefits

The income tax provisions regarding annuity death/survivor benefits are complex. Part of this complexity is due to IRS requirements on how quickly the beneficiary must receive the death benefits.

If the contract has been annuitized (i.e., the contract has been paying annuity payments to the decedent), the IRS requires that any remaining payments to beneficiaries be paid at least as rapidly as was the case before the decedent's death. In other words, beneficiaries may take remaining payments more quickly, but cannot extend the payout period. If any portion of the annuity still contains principal, that principal will be returned to the beneficiary tax-free, then any taxable earnings will be paid. This is a FIFO-type distribution: tax-free return of principal first, then taxable earnings. After the contractholder's death, all income tax liability on future annuity payouts is the responsibility of the beneficiary who receives the payout.

If the contract remains in the accumulation phase at the time of the contractholder's death, the income tax rules become very complex. Annuity contracts can be either "annuitant-driven" or "owner-driven". These terms refer to whose death will trigger payment of death benefits. if the contract pays death benefits upon the death of the annuitant, it is an annuitant-driven contract. If the death benefit is payable upon the death of the contractholder, it is an owner-driven contract. In most cases, the owner and annuitant are one in the same, so this becomes a distinction without a difference. But there are situations in which one person owns the contract, and the measuring life (the annuitant) is someone else.

It would be nice to think that a particular contract is either owner-driven or annuitant-driven, but it is not that simple. All annuity contracts issued since January 18, 1985 are owner-driven because no annuity contracts issued since then will be granted tax-deferred status unless it contains language that triggers a payout upon the contractholder's death. To keep their tax status, annuity companies make sure their contracts provide payout upon the contractholder's death. That is not to say, however, that the contract cannot also provide for death benefits to be paid if the annuitant dies, too. And there are other complications: the "owner" for certain tax purposes must be a "natural person", so contracts held by trust or corporations may have another person named as "owner". With these caveats in mind, let's turn our attention to the distribution options available when the contract is still in the accumulation phase at death, and the annuity is “owner-driven”..

The general rule is that the beneficiary must take the contract's entire death benefit within five years of the contractholder's death. There are two exceptions to this general rule, and both are available only to "designated beneficiaries", which the tax code defines as "any individual designated a beneficiary by the holder of the contract". The key word is "individual" — meaning a natural person, not a corporation, trust or other non-human entity. (Please note: while new "look-through" language applies to distributions from IRAs to trusts as beneficiaries — those more-lenient rules do not apply in the case of death payments from annuities paid into a trust.) This five-year general rule and two following exceptions apply only when the owner's death triggers the payout. Annuitant-driven payouts are discussed below.

The first exception to the general five-year rule for individual beneficiaries is to accept the death benefit over a longer period, not to exceed the expected lifetime of the beneficiary. This allows the beneficiary to take the death benefits as an annuity payable for a lifetime or some shorter period. If the beneficiary elects to take the death benefits in this method, the benefits are taxed like any other annuity payments: partly as tax-free return of principal and partly taxable income. The exclusion ratio is found by using the deceased contractholder's cost basis and the expected payouts based on the beneficiary's life expectancy (of shorter period, if that is what the beneficiary chooses). [A few annuity companies allow beneficiaries to use a fractional method instead of annuitizing the death benefit. In this method, sometimes called a "stretch annuity", the beneficiary takes a withdrawal each year — the required amount of each year's withdrawal is based on the same tables used to calculate the required distributions from an IRA. There are two advantages to this method. One, the account is not annuitized so the beneficiary retains control over the cash value in the contract. Two, smaller payments are allowed in the earlier years, leaving more in the contract to grow tax-deferred (or put another way, less will be taxed in the early years). In is unclear whether the IRS will tax this series of withdrawals the same as annuity payments, i.e., apply an exclusion ratio, or whether the beneficiary will be taxed on a LIFO basis, earnings first, then principal.] Regardless of whether the beneficiary annuitizes the death benefit or takes periodic withdrawals, the beneficiary must begin to receive the death benefits under this exception no later than one year after the contractholder's death. There are inconsistencies in the wording of tax code that might require the beneficiary to make a decision to use this exception to the general five-year rule within 60 days of death.

The second exception to the five-year rule is available only to a surviving spouse. If the designated beneficiary is the contractholder's spouse, the spouse may elect to "step into the shoes" of the decedent. In effect, the spouse is treated as if he or she were the owner of the annuity from its inception. In this case the spousal beneficiary can continue to hold the annuity in the tax-deferred accumulation period indefinitely. Please note this applies only if the spouse is named as a "designated beneficiary"; it is not available, for instance, if a trust is the beneficiary and the spouse is the trustee.

The general five-year rule and the two exceptions only apply to owner-driven annuities, not annuitant-driven contracts. Annuitant-driven contracts will pay death benefits when the annuitant dies. An annuitant-driven contract might be an older contract, issued prior to 1985, or it may be a newer contract that triggers a death benefit if either the annuitant dies (under the contract's terms) or the contractholder dies (under the tax code). For purposes of this discussion, assume that the annuitant and the owner are different. If the contract is annuitant-driven and the annuitant dies, the death triggers the death benefits — and the beneficiary has 60 days to decide how to take the death benefits subject to the terms of the annuity contract. If not annuitized within 60 days, the benefit will be taxed as though it were received in a lump-sum surrender, i.e., the cost basis will be returned tax-free, and any excess will be taxable in the year of the annuitant's death. Also note that the option of a spouse to "step into the shoes" of the owner will not be available — that exception applies only when the owner has died — but the owner didn't die in the instance, the annuitant did. Lastly, if the beneficiary is under age 59½, the "death" exception to avoid the 10% penalty will not apply to a premature distribution — again, because that is available only on the death of the contractholder (not the death of the annuitant). For these reasons, it is rarely a good idea to establish an annuitant-driven contract unless the owner and the annuitant are the same person. In fact, many annuity companies have internal underwriting policies that refuse to issue contracts that name a different owner and annuitant. (There may be odd situations in which an annuitant-driven contract fulfills a client’s unique needs, but more often than not the tax disadvantages will outweigh the benefits.)

Jointly-owned annuities may pose similar problems — or at least they may not serve the estate planning function that other jointly-held assets do. Under the owner-driven annuity tax rules, death benefits are triggered upon the death of any owner. As a result, the death benefits must be paid out within five years of the first owner's death, or subject to the two exceptions (annuitization or spousal continuance). If an annuity is held jointly between a husband and wife it would appear that if one were to die, the other could simply continue ownership under the spousal continuance exception. But that exception only applies if the "designated beneficiary" is the spouse. Assume that the husband and wife named their son as beneficiary of their jointly-owned annuity. Upon the death of either owner, the company must pay the death benefits to the son, who is the beneficiary, not the surviving spouse — and this would probably defeat the owner's intentions. At a minimum, this example points out the complexity and uncertainty that jointly-held annuities pose. Some financial planners use jointly-owned annuities when planning for long-term care needs — jointly-owned annuities are sometimes useful in divesting assets to qualify for Medicaid nursing home benefits. Financial advisors should be very careful before recommending the joint ownership of annuities. If a jointly-owned annuity is deemed appropriate, the advisor should seek expert tax advise, carefully review the terms of the contract, and the issuing company's internal administrative policies to improve the chances of the contract ending the way it was planned.

Annuities and Trusts

A particularly troubling set of tax problems can arise when an annuity is owned by a trust, or a trust is named as beneficiary of an annuity. A trust is not a natural person — therefore it cannot die. This means that all trust-owned annuities must rely on a separate annuitant as the measuring life (i.e., the owner and the annuitant are necessarily different). Put another way, all trust owned annuities must also be annuitant-driven annuities. As we just learned, annuitant-driven contracts are more likely to lead to unintended consequences than owner-driven contracts.

Often a financial advisor will recommend that all of a client's assets should be placed within a revocable living trust for estate planning purposes. But this recommendation is usually made without a full understanding of the tax rules governing annuities and trusts. Moreover, placing an annuity within a trust may conflict with the rest of the client's estate plan. In most cases, there is little benefit to owning an annuity within a trust. Trusts are usually set up to avoid probate; but an annuity's death benefit passes "by contract" to the beneficiary, so it will pass outside probate anyway. Sometimes trusts are employed to provide more flexible distribution of the proceeds than simply naming an individual; but the trust could be named as beneficiary without being also named the owner. Or perhaps there is a fear that the owner may become incompetent, Alzheimer's for instance; but a durable power of attorney would address that fear. In light of the problems that can arise from trust-owned annuities and the availability of reasonable alternatives, it rarely makes sense for a trust to own an annuity.

If a trust is named as a beneficiary, there is a different set of possible adverse outcomes. Since a trust cannot be a "designated beneficiary", if death benefits are payable during the accumulation phase, they must be taken under the general five-year payout rule. The annuitization or spousal continuation exemptions apply only to designated beneficiaries (i.e., individuals, not trusts). There are some situations when naming a trust as beneficiary may provide greater flexibility in distributing the contract's death benefits. If the need for flexibility outweighs the less-favorable distribution rules, naming a trust as beneficiary may make sense. Financial advisors should be very careful when recommending a trust as an annuity's beneficiary. They should fully understand the tax code on this issue, the wording of the contract, and the administrative policies of the annuity company.

To summarize some of these pitfalls, advisors should:

- avoid naming a trust as the owner of the annuity unless there are clear reasons for doing so and understand all of the ramifications of that designation
- avoid naming a trust as beneficiary of an annuity unless there are clear reasons for doing so and understand all of the ramifications of that designation,
- avoid co-ownership of an annuity,
- avoid naming different individuals as owner and annuitant, and
- if the owner and annuitant are different individuals, confirm whether the contract is annuitant-driven or not.

Qualified Annuity Plans

A qualified plan is a tax-deferred arrangement established by an employer to provide retirement benefits for employees. It "qualifies" for special tax treatment if it complies with various government requirements known as the Employee Retirement Income Security Act (ERISA). A qualified annuity is an annuity purchased as part of a tax-qualified employer-sponsored retirement plan – or individuals can purchase qualified annuities within their Individual Retirement Account (IRA).

Employers commonly use annuities to pay their pension benefits. Many defined benefit plans are called "annuity purchase plans" for this reason. With the advent of ERISA and tax-qualified retirement plans, annuities used in defined benefit plans gained special tax status. Simply put, monies that are contributed by employers or employees to qualified retirement plans are tax deductible, and earnings grow in the plan tax-deferred. This allows for more rapid growth in the plan. When monies are disbursed to retired employees, the full amount of the pension benefit is subject to tax as ordinary income. Withdrawals prior to retirement might be possible under certain circumstances, depending on the plan's language. Withdrawals from qualified plans are also fully taxed as ordinary income. Withdrawals from qualified retirement plans prior to age 59½ are also subject to a 10% penalty. This penalty is waived in the event of death, disability, or if the payouts are structured as a series of payments to be paid over the participant's lifetime. This 10% penalty is similar to the penalty for premature withdrawals from a deferred annuity discussed above (although it is important to note that the penalty in the case of deferred annuities applies to only the earnings portion of the withdrawal. In the case of qualified retirement plans, the 10% penalty applies to the entire withdrawal.) The IRS also requires retirees to begin to take distributions from qualified plans (and traditional IRAs) at age 70½ — or face a 50% penalty. There is no such requirement or penalty for nonqualified ("regular") annuities.

A full discussion of the various types of qualified plans is beyond the scope of this program. Generally speaking benefits paid from qualified retirement accounts are fully taxable as ordinary income (because the contributions were made in pre-tax dollars and the earnings grew tax-deferred). There are a couple of exceptions worth noting. Some contributions to IRAs are not tax deductible, that is, the contributions are made in after-tax dollars. For those contributing after-tax dollars to their IRAs, a portion of the eventual withdrawals will be tax-free return of principal (using a variation on the exclusion ratio). Roth IRAs and Roth 401k plans operate on a different premise: after-tax dollars are contributed, the account grows tax-deferred, and if the participant keeps the contribution in the account for at least five years, withdrawals (taken after age 59½) will be tax-free. If taken before age 59½ or before the funds have been in the account for five years, the earnings will be taxable as ordinary income (principal is returned tax-free). Premature withdrawals from Roth accounts are taxed on a FIFO basis (return of tax-free principal first, then taxable earnings), but there is no 10% penalty.

A **Tax Sheltered Annuity**, or TSA, is a special type of annuity plan reserved for employees of educational and nonprofit organizations. These plans are also called "403(b) plans" or a "501(c)(3) plans," after the sections of the Tax Code that make them possible. Through these sections of the tax code, the federal government has encouraged specified nonprofit charitable, educational and religious organizations to set aside funds for their employees' retirement. Funds set aside in a TSA are not included in the employee's current taxable income. In other words, all contributions to a TSA are made with "before-tax dollars". This is true whether employers contribute funds on behalf of their employees or the employee contributed funds through a reduction in salary. These ongoing contributions are paid into a deferred annuity (fixed, variable or indexed). Like all annuities, earnings in the annuity grow tax-deferred.

Most TSAs are primarily funded by an employee's contributions through a salary reduction agreement with an employer. A fixed amount of money is deducted from each paycheck before taxes are taken out. The TSA contributions then grow on a tax-deferred basis. The maximum amount that can be contributed to a TSA each year is the same as for 401k contributions — and this amount is adjusted periodically for inflation. In 2009, a TSA participant can elect to contribute a maximum of $16,500 ($15,500 in 2007 and 2008). For older employees (age 50 and above), additional "catch-up" contributions are allowed ($5,500 in 2009, $5,000 in 2008 and 2007). A TSA may also be partially funded by contributions from the employer. The employer may make matching contributions or contribute a fixed percentage of an employee's compensation to the TSA — again, subject to limits similar to 401k plans.

Upon retirement, the tax-sheltered annuity can be annuitized to provide retirement benefits. All payments received by employees from the accumulated savings in tax -sheltered annuities are taxable income (there is no exclusion ratio, since the contributions were made with before-tax dollars and earnings grow tax-deferred). When employees retire they usually find themselves in a lower tax bracket, so retirement income payments from the TSA are likely to be taxed at a lower rate than the income that was sheltered during their working years.

In summary, annuities can be used in a qualified retirement account for a couple of different purposes — deferred annuities in their accumulation phase provide an investment vehicle during an employee's working years, and upon retirement immediate annuities can provide a means to distribute lifetime pension benefits. In fact, the federal law governing pension plans requires payouts to married retirees to be in the form of a joint and survivor annuity (unless waived in writing by the spouse). This protects a surviving spouse in the event the employee dies.

As we'll see in the next chapter, many (larger) employers use group annuities to cover their workforce. Individual annuities are better suited for Individual Retirement Accounts, or for employers who wish to cover a few employees.