# Taxation of Annuities: Most FAQ

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Annuities come in a variety of shapes and sizes: non-qualified, qualified, variable, fixed, index, deferred, immediate—you get the idea. In my role as an advanced planning consultant, I find that financial professionals may struggle with the tax complexities associated with annuities, particularly when dealing with an already tax-deferred source of funds, such as qualified monies or when a non-natural owner is considered.

This month's Advanced Markets, Explained white paper will focus on the most frequently asked tax questions that I receive from financial professionals.

**Note:** Encourage your clients to work with their tax professional to ensure that the strategies discussed are right for them and align with any broader tax strategy. The goal is to maximize tax-efficient retirement income.

## What is the difference between a deferred annuity and an immediate annuity?

A deferred annuity (DA) is a contract with an insurance company that promises to pay income at some future date in exchange for ongoing contributions or a lump sum contribution. In contrast, an immediate annuity (IA) is purchased with a single lump sum in exchange for payments that begin within one year of purchase.

## Are DAs and IAs taxed the same way?

Generally speaking, no. DAs are generally taxed on a last-in, first-out basis (LIFO), meaning withdrawals first come from taxable earnings. Once earnings are depleted (on a non-qualified contract), the basis, or initial premiums paid to fund the contract, are returned tax-free. Any taxable portion of a withdrawal is taxed as ordinary income.

**Note:** Cost basis established prior to August 14, 1982, referred to as pre-TEFRA basis, comes out on a first-in-first-out basis (FIFO). Policies that contain pre-TEFRA basis must separately account for this grandfathered basis to get the more favorable FIFO tax treatment on that portion of the basis.[1]

If the DA is qualified, meaning it's an IRA, for example, withdrawals are fully taxable unless there is basis in the policy from after-tax contributions (or non-deductible contributions). If an IRA also has after-tax contributions, any subsequent withdrawals will be taxed on a pro-rata basis; a percentage of each withdrawal will be a return of basis and pre-tax monies. Keep in mind that all IRAs are combined when determining how much of the withdrawal will be taxable when there are after-tax contributions in any of the IRAs owned by the owner.[2]

Non-qualified immediate annuities, on the other hand, are taxed on a preferred basis, known as exclusion ratio treatment. The exclusion ratio refers to the portion of each immediate annuity payment that is not subject to taxes. Unlike a withdrawal from a deferred annuity that is taxed LIFO, each immediate annuity payment is calculated such that the percentage the cost basis bears to the payments is tax-free.[3]

*Example: Mary, age 60, purchases a single premium immediate annuity*

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*(SPIA) in January 2020 with $300,000. Mary will receive her first annual payment in January 2021 over a 10-year period. $30,000 of each annual payment will be tax-free. The portion of the annuity payment over $30,000 will be taxable.*

## If my client elects to turn on income on her non-qualified annuity, will the income payments be given the more favorable exclusion ratio treatment?

The answer is no, even if income is turned on within the first 12 months of purchase. Unlike an immediate annuity payment, which is irrevocable once elected, an income rider has flexibility and, therefore, does not fall under the definition of an immediate annuity for purposes of applying the exclusion ratio tax treatment. LIFO treatment will apply.

## Are there exceptions to the 10% early withdrawal penalty on non-qualified annuities?

While the list of exceptions is far shorter than those that apply to qualified retirement accounts, like IRAs, there are exceptions to the 10% early withdrawal tax that apply to the taxable portion ONLY for a non-qualified annuity withdrawal, prior to age 59 ½.

Exceptions to the early withdrawal tax on a non-qualified policy are:[4]

1. Attainment of age 59 ½.
2. The owner is disabled within the meaning of IRC 72(m)(7).
3. The contract owner dies.
4. The gain on Pre-TEFRA contributions (prior to August 14, 1982).
5. Immediate annuity (defined previously).
6. A series of substantially equal periodic payments based on the life expectancy of the owner that continues for the longer of five years or attainment of age 59 ½. This is often referred to as “72(q) payments.”

**Note:** The immediate annuity exception only applies to non-qualified policies in which the SPIA is purchased from an outside source of funds, rather than from a previously deferred annuity. The immediate annuity exception never applies to a qualified annuity contract.

For a full list of exceptions to the 10% early withdrawal tax on qualified plans and IRAs, visit https://www.irs.gov/retirement-plans/plan-participant-employee/retirement-topics-tax-on-early-distributions.

*Example: Ronald, age 56, elects to 1035 exchange a non-qualified deferred annuity policy to an immediate annuity. Because the funds in the new SPIA were previously deferred, the 10% penalty would apply to the taxable portion of his payments until he reaches age 59 ½, unless Ronald opted to set up a series of payments based on his life expectancy or meets another exception mentioned above. The immediate annuity exception would not apply in this scenario.*

*Conversely, had Ronald funded the SPIA with “new money,” meaning money that was not previously in a non-qualified annuity, the taxable*

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*portion of his income payments would not be subject to the 10% penalty, regardless if he chose a period certain or a lifetime payout structure.*

## Can a non-qualified annuity be owned by a non-natural owner?

The short answer is yes, but non-natural ownership may change the tax treatment of subsequent withdrawals.

In general, a policy owned by a non-natural person ceases to be treated as an annuity contract, therefore, the income on the contract, or gain on the policy, must be taxed in the year that it is earned, rather than being tax-deferred until withdrawn. Examples may include a corporate or charity-owned policy.

So, for example, a corporate-owned policy will be taxed annually on any earnings. For this reason, some carriers do not permit corporate-owned policies. Check with your marketer to determine which carriers permit corporate or charity-owned policies.

### Agent for a Natural Person Exception

An exception to the current taxation of earnings on a non-natural owner policy is if a trust or other entity owns the policy as an "agent for a natural person." This would apply to a revocable or irrevocable trust owned for the benefit of natural persons, an estate or trust-owned policy on behalf of a deceased person, or a qualified trust in the case of a retirement plan.[5] In such cases, tax deferral is permitted until withdrawal.

**Practical note:** In addition to the standard application, a non-natural ownership form must be submitted with the application for all non-natural owner policies.

## Is there a tax implication if my client wants to change the owner of their non-qualified annuity?

Yes, with limited exceptions. Change of ownership may occur by adding or removing a joint owner, transferring the policy to another entity or owner, or assignment of the policy. In all three instances, the earnings on the policy at the time of transfer are taxable to the original owner(s) and the 10% penalty for early withdrawal may apply to the taxable portion if the existing owner is under ager 59 ½. Further, the change of ownership is considered a gift and may require that gift taxes be paid.

The exceptions to the rules outlined above are:

1. A transfer of ownership from one spouse to another or the addition or deletion of a spouse
2. A transfer of ownership pursuant to a divorce
3. A transfer of ownership between the owner and his/her revocable (grantor) trust

*Example: Switching ownership between spouses*

*Non-qualified annuity policy A is co-owned by husband and wife, Robert and Barbara. The couple would like to 1035 exchange the policy to a new carrier into Policy B. Robert is 87 years old and the carrier they have chosen will not accept an issue age above 85. To circumvent this challenge, Robert and Barbara request to change the ownership on Policy A to Barbara only, who is 80, and then proceed with the 1035 exchange to Policy B.*

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*Example: Switching ownership from an individual to his/her grantor trust*

*Susan has recently created a revocable living trust with the help of her attorney. On the advice of her attorney, she would like to re-title her non-qualified annuity to her trust. Susan may submit a change of ownership form to her annuity carrier for the non-qualified annuity and will incur no tax liability on the gain. However, when she passes, the policy must be distributed within five years of her death. The acceleration of taxes due is often an unintended consequence when a policy is re-titled to a revocable trust. The same trust should be named as the beneficiary of the policy and the five-year rule applies upon death of the grantor.*

**Practical Tip:** If the intent of the trust is to avoid probate, annuities and life insurance policies avoid probate simply by naming a designated beneficiary, making a trust for that purpose unnecessary.

It's wise to encourage your clients that are considering a change of ownership to further explore the tax consequences of doing so with their attorney.

**Qualified Annuities and Required Minimum Distributions (RMDs)**

## My client, age 73, owns two IRAs, one is a deferred annuity, and the other is a SPIA. The income she receives from her SPIA is enough to satisfy the RMD for both the SPIA IRA and the deferred annuity IRA. Is it okay if she doesn't take a RMD from her second annuity?

The answer to this question is a resounding no, and it's one that catches some financial professionals off guard. Once a policy is annuitized, the RMDs only satisfy the RMDs from that policy. Had both been deferred annuities, the answer would be different. An individual who owns multiple IRAs must separately calculate the RMD for each, but may satisfy the total RMD from one of more of them. This permissive aggregation rule does not, however, apply once a policy is annuitized, regardless of the term of the payout period.[6]

## What are the post-death RMD rules for a beneficiary of an annuity?

If the annuity is a qualified annuity, such as an IRA or 401(k), the SECURE Act changed the post-death RMD rules for most beneficiaries by accelerating the distribution period to 10 years for deaths on or after January 1, 2020. Some exceptions apply for "eligible designated beneficiaries." For a more detailed discussion of the post-SECURE Act effect on beneficiary options, refer to the Advanced Markets, Explained white paper "Navigating the New Landscape of Legacy Planning After the SECURE Act."

The SECURE Act did not change the post-death beneficiary options on non-qualified annuity contracts. Therefore, a non-spousal beneficiary has three options:[7]

1. Stretch annual distributions over a period based on his/her life expectancy beginning within one year of the owner's death.

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2. Distribute the policy within five years of death, with no annual distribution requirement.

3. Lump-sum distribution.

A non-natural beneficiary such as a trust or an estate must apply either option two or three. Therefore, it's wise to determine if the use of a trust in conjunction with a non-qualified annuity and the subsequent acceleration of post-death withdrawals aligns with the overall goals of the legacy plan.

A spousal beneficiary maintains the right to become the holder of the contract either through spousal continuation or by 1035 exchanging the existing policy into another one in his/her name.

**Note:** If the policy has been annuitized, the beneficiary must continue to receive the remaining payments, if any.

## My client's mom recently passed and named him as the beneficiary of her non-qualified annuity. He would like to move the inherited monies to another carrier. Is he permitted to do a 1035 exchange on an inherited non-qualified annuity?

This has been a long-standing area of uncertainty, but the pendulum continues to move to a yes as more and more carriers are willing to process a post-death 1035 exchange on behalf of a non-spousal beneficiary. Private Letter Ruling 201330016 laid the groundwork for the IRS's position by permitting a non-spousal beneficiary to 1035 exchange one deferred annuity to another.

Because a private letter ruling only applies to the taxpayer requesting the ruling, it cannot be relied upon as general principle but, instead, provides an indication of how the IRS would view a similar situation.

When you are working with a scenario like this one, you must first determine whether the existing non-qualified carrier will permit a 1035 exchange to an inherited annuity with another carrier. If the answer is yes, the next step is to find a carrier that's willing to accept an inherited annuity. Start by reviewing the death claim form of the existing carrier. Your marketer can help you navigate those options.

Under no circumstances should the non-spousal beneficiary take receipt of the monies with the intention of rolling over within 60 days. No such action is permitted in either the non-qualified or qualified arena and would make the distribution taxable.

## When in doubt, reach out.

The complexities surrounding the tax rules of annuities sometimes require back up. If you are in doubt about the consequences of a scenario your client is facing, contact your marketer and always encourage your clients to seek reputable counsel from a tax professional before taking a course of action.

## Sources:


[1] https://www.immediateannuities.com/taxation-of-annuities/

[2] IRS Publication 590-B: Distributions from Individual Retirement Arrangements (IRAs), 2019.

[3] www.investopedia: Exclusion Ratio, January 2020.

[4] IRC 72(q)(2)

[5] IRC 72(u)(B)

[6] §1.401(a)(9)-6 Required Minimum Distributions for defined benefit plans and annuity contracts

[7] §72(s) Required Distributions Where Holder Dies Before Entire Interest is Distributed



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