Nonqualified annuities

In brief

ANNUITY CONTRACT TERMINOLOGY IS NOT UNIFORM

Annuities offer great features like tax-deferred growth and income for life, but they can sometimes be difficult to plan with because the terminology used in annuity contracts is not necessarily consistent from insurance company to insurance company (or contracts series to contract series within one company). As such, the powers or benefits held by those labeled "annuitant," "beneficiary," or other terms can be non-intuitive and differ from contract to contract. Annuity owners and their advisors should carefully read and understand their particular contract.

Parties to an annuity contract

Issuer. The insurance company (or other party) that is obligated to make payments under the contract.

Holder. The owner of the contract who possesses the contract rights (for example, to decide how and when the contract distributes payments, to sell the contract, and to give the contract away).

Annuitant. The measuring life of the contract. The annuitant's age determines when the contract matures. The annuitant's age can also measure the duration of payments from the contract. The annuitant might or might not be the recipient of the payments.

Payee. The party who receives distributions from the contract.

Successor owner. The new owner of the contract after the original owner dies, usually where the original owner was not also the (still-living) annuitant.

Contingent annuitant. The new annuitant (if any) of the contract after the primary annuitant dies.

Beneficiary. The party who receives death benefit or survivor benefit upon death of annuitant. In many contracts the death benefit is payable only if the deceased annuitant was also the owner. What's more, if the deceased annuitant was also the owner and the contract does not mature by virtue of the owner/annuitant's death, the beneficiary becomes both the new owner and the new annuitant.

- If annuitant dies while the contract is in its deferral or accumulation phase, the amount payable to the beneficiary is called a "death benefit."
- If annuitant dies while the contract is in its annuity income phase, the amount payable to the beneficiary is called a "survivor benefit."
- Unlike life insurance death benefit, an annuity contract's death benefit or survivor benefit is not income tax free, but instead is taxable to the extent it exceeds basis.

Taxpayer. The person who owns the contract, or controls the right to payments. Neither the annuitant nor the payee is necessarily the taxpayer, as at times neither may own the contract nor control its payments. Where a "grantor trust" under Internal Revenue Code sections ("I.R.C. §§") 671-679 owns the contract, the taxpayer is the individual grantor instead of the trust. See Priv. Ltr. Rul. 202031008 (July 31, 2020).

(REV 0921)

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CLASSIFICATION OF ANNUITY CONTRACTS

Tax treatment

Qualified annuities. Owned by or received in conjunction with a qualified pension plan, traditional IRA, 401(k), 403(b) plan or similar arrangement. Contributions are generally deductible or excludible from income, within contribution limits. Subject to required minimum distribution rules after the owner reaches the required beginning date (later of age 72 or retirement). Grow tax-deferred.

Nonqualified annuities. Not owned or received in conjunction with a qualified pension plan or similar arrangement. Contributions are not deductible or excludible from income, but there are no contribution limits. The owner reaching age 72 does not force distributions. Grow tax-deferred.

Commencement of distributions after contribution(s)

Immediate. Annuity Starting Date is within one year of first (and only) premium.

Deferred. Annuity Starting Date is not within one year of first premium.

Income annuities. Income Annuities are those that offer distributions only in the form of an annuitization (that is, as an income plan). They can be **Immediate Income Annuities** (starting payments within one year after purchase) or **Deferred Income Annuities** (which don't start payments within one year of purchase, and are also called Longevity Contracts).

Control and risk of investment

Fixed annuities. Insurer controls and bears risk of investment. Insurer guarantees a minimum rate of growth during deferral. After being settled to an annuity stream, each annuity payment will be at least a minimum amount.

Variable annuities. Contract owner controls and bears risk of investment. Insurer does not guarantee minimum growth during deferral. After being settled to an annuity stream, each payment amount will fluctuate based on the performance of the underlying investment. Premiums are called "purchase payments," and they buy "accumulation units" during deferral, which are settled to "annuity units" during the annuity income phase.

Portfolio annuities. A type of fixed annuity where the contract offers not only guaranteed minimum income payments, but also potential for increased growth and payments based on non-guaranteed dividends.

Number of measuring lives

Single life annuity. Annuity payments measured by one annuitant's life.

Joint and survivor annuity. Annuity payments measured by lives of two annuitants, continuing at least until last-to-die. Payments to survivor may be same amount, or only 2/3 or 1/2 as large as when both annuitants were alive.

Method of paying annuity (income plan)

Straight (pure) life. Annuity payments continue until the death of the annuitant(s).

Life with period certain. Annuity payments continue for later of a time period (for example, 10 or 20 years); or annuitant's death.

Installment refund. Annuity payments continue until later of: death of the annuitant(s); or until at least the contract's value when annuitized.

Period certain. Annuity payments continue for a specific number of years (for example, 20 years), regardless of how soon the annuitant dies or how long the annuitant lives.

INCOME TAX: ACCUMULATION PHASE

Growth during accumulation phase

Tax-deferred growth. Cash value growth in annuity contracts is generally not subject to current income taxation.

Non-natural person rule. If the contract is held by a non-natural person (for example, a trust), the cash value growth is taxed as ordinary income each year, unless the non-natural person holds the contract as an agent for a natural person (or, if a trust simply holds it "for" a natural person; see Priv. Ltr. Rul. 202031008 (July 31, 2020)).

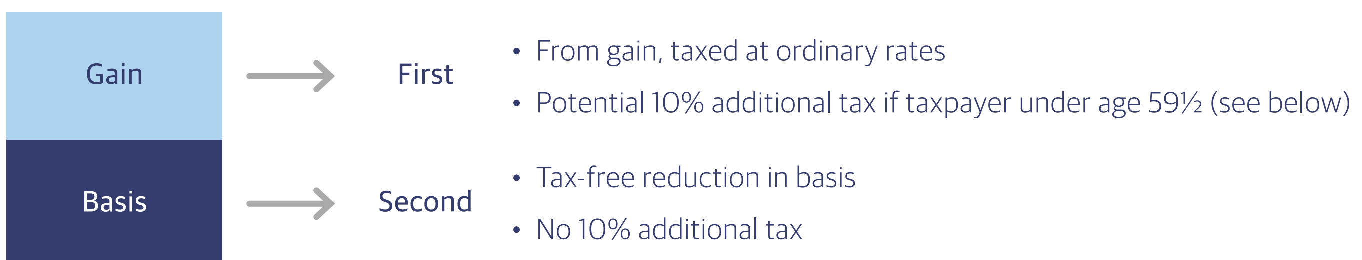
Withdrawals during accumulation phase

Distributions from the annuities during the accumulation / deferral phase are "amounts not received as an annuity," and are taxed as described below.

Ordering. The order of withdrawals is as follows:

- First, taxable gain is distributed. Gain is taxed at ordinary income rates, and is also subject to the 3.8% net investment income tax for taxpayers over certain income thresholds. Gain is called "income on the contract."
- Second, basis is distributed tax-free. The basis is called "investment in the contract."

Loans. Borrowing from the contract or pledging it as collateral is treated as a withdrawal, triggering tax on any gain. The amount of the loan that is taxed is added to the contract's basis.



Pre-August 14, 1982. The above rules are different for withdrawals of cash value due to contributions prior to August 14, 1982: the ordering is reversed (tax-free basis is distributed first), loans are not treated as withdrawals, and there is no 10% penalty tax.

INCOME TAX: ANNUITY INCOME PHASE

Maturity

Maturity date. The maturing of the contract marks the end of the accumulation phase (as well as the end of tax-deferred growth), and amounts must be distributed from the contract. A contract's maturity date is when the annuitant reaches maturity age (often age 98).

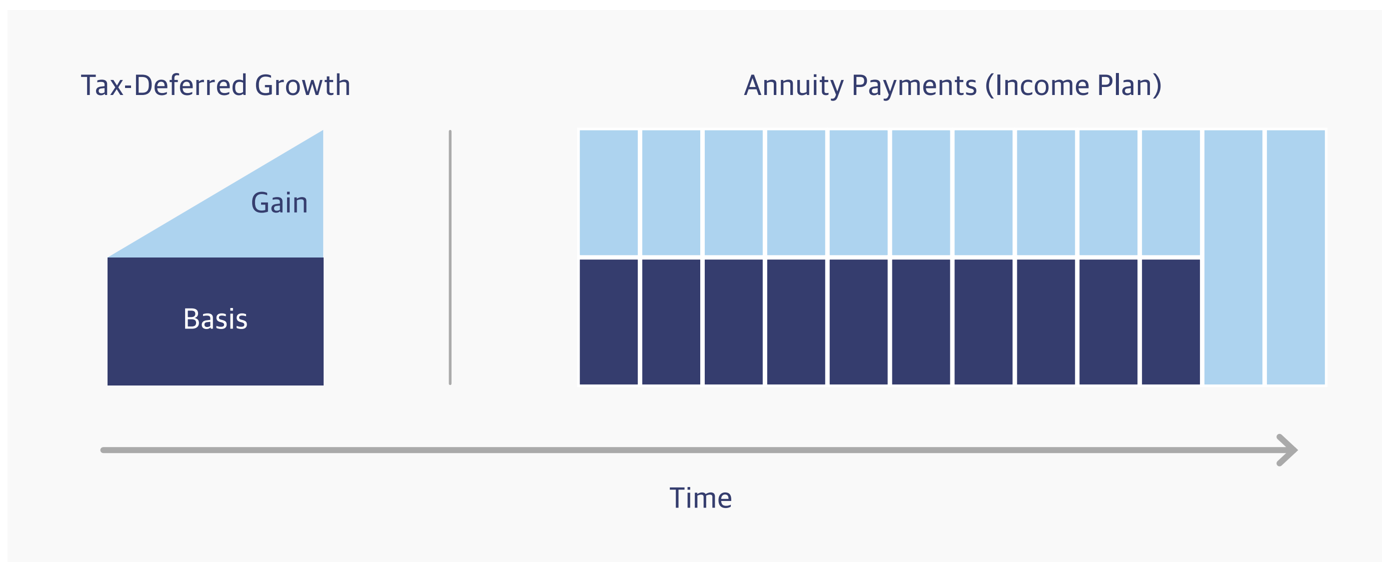
Withdrawals as annuity payments (income plan)

Annuity starting date. If the owner elects to receive amounts from the contract "as an annuity," the annuity starting date marks the beginning of those payments and also is when the exclusion ratio is determined.

Exclusion ratio. Each payment received "as an annuity" is part tax-free return of basis and part taxable gain. Gain is taxed at ordinary income rates, and is also subject to the 3.8% net investment income tax for taxpayers over certain income thresholds. The 10% additional penalty also applies to the taxable portion of annuitized payments, unless an exception applies (see next page). The tax-free portion of each payment is determined by multiplying each payment by the exclusion ratio.

$$\text{Exclusion Ratio} = \frac{\text{Investment in the Contract (Basis)}}{\text{Expected Return}}$$

The exclusion ratio is applied only until all investment in the contract (basis) is recovered, after which each payment is taxed in full.



EARLY WITHDRAWAL 10% PENALTY TAX

- The taxable portion of any distribution from an annuity contract – whether taken before the annuity starting date ("not as an annuity") or after the annuity starting date ("as an annuity") – is potentially subject to an additional 10% penalty tax.
- This penalty tax applies only to the taxable portion of the distribution, not the portion from tax-free basis.
- Annuities are granted tax deferral to encourage their use for retirement. The early withdrawal penalty – and its exceptions – are generally meant to discourage taxpayers from taking advantage of tax deferral by taking distributions before reaching retirement age.
- Exceptions to the 10% penalty for nonqualified annuities are similar, but not identical, to the exceptions for qualified plans and IRAs. For nonqualified annuities, exceptions include:
  - Taxpayer is age 59½ or older. Where the owner and the annuitant are not the same, the relevant age is that of the owner, not of the annuitant.
  - Death of holder (or if annuity is trust-held, death of annuitant).
  - Disability of taxpayer (this is generally the owner of the contract, not necessarily the annuitant). Insurance companies generally do not take notice of a taxpayer's disability when issuing a Form 1099R, and thus will often indicate the 10% penalty as applying for owners under age 59½. The taxpayer then claims the disability exception by subsequently fling a Form 5329.
  - Series of substantially equal periodic payments over taxpayer's life (SOSEPP-for-life).
    - Annuitizing a contract for a period shorter than life or life expectancy generally does not meet this exception.
    - Portfolio income annuities – even if annuitized for life – generally do not meet this exception, as the dividends tend to render the payments as not "substantially equal."
    - Variable income annuities generally can meet this exception if annuitized for life. The dollar amount of each variable payment can differ, but they are nonetheless deemed "substantially equal" because each annuitized payment represents the liquidation of the same number of "annuity units." See Priv. Ltr. Rul. 200818018 (May 2, 2008).
  - Immediate annuities.
    - This exception requires not only that the annuity starting date not be more than one year after purchase, but also that payments be "substantially equal periodic payments" (though not necessarily for the life of the taxpayer). This means that Portfolio Income Annuities generally do not meet this exception, even if payments begin within one year after purchase.
    - Deferred annuities do not become immediate annuities simply because they are annuitized.
- It can be difficult for annuities held by irrevocable trusts to meet most 10% penalty exceptions, as trusts do not have an age, cannot become disabled, and do not have a life expectancy. If the trust is a "grantor trust" under I.R.C. §§ 671-679, however, the individual grantor is the relevant taxpayer.

REQUIRED DISTRIBUTIONS

Annuitant's age. There is no federal tax law that requires distributions from a nonqualified annuity upon the annuitant reaching a certain age. But the provisions of most annuity contracts require some type of distributions after the annuitant reaches the contract's maturity age, often age 98.

Annuitant's death. There is no federal tax law that requires distributions from a nonqualified annuity upon the annuitant's death, unless the contract is owned by a non-natural person. But many annuity contracts automatically mature upon the annuitant's death – requiring some type of distributions – unless the contract has a contingent annuitant feature.

Owner's age. There is no federal tax law that requires distributions from a nonqualified annuity upon the owner reaching a certain age. This is in contrast to the rules for qualified plans and IRAs, which generally require distributions after the owner reaches age 72.

Owner's death. Section 72(s) of the Internal Revenue Code requires distributions from a nonqualified annuity after the death of any contract owner. If the owner is a non-natural person such as a trust, these rules are triggered by death of the annuitant. These rules are similar – but not identical – to the post-death required minimum distribution rules for qualified retirement plans and IRAs (particularly how those rules worked before the SECURE Act became effective in 2020). The rate at which post-death distributions must be made depends on:

- whether the owner died before or after annuitizing the contract; and
- the identity of the "designated beneficiary." This the person who controls the contract after death, and might acquire that control by being labeled the contract's "beneficiary," its "successor owner," or some other term.

I.R.C. § 72(s) distribution at death rules

<table>
<tr><th></th><th>DEATH PRE-ANNUITY STARTING DATE</th><th>DEATH POST-ANNUITY STARTING DATE</th></tr>
<tr><td>General Rule</td><td>Entire contract must be distributed within 5 years after death.</td><td>Distributions must continue at least as rapidly as before death.</td></tr>
<tr><td>Exception if designated beneficiary is individual</td><td colspan="2">Individual designated beneficiary may stretch payments over a period not to extend beyond that beneficiary's life or life expectancy, but distributions must begin within one year after death. This exception applies for both death before and after annuity starting date.</td></tr>
<tr><td rowspan="2">Exception if designated beneficiary is spouse</td><td colspan="2">Spouse designated beneficiary is "treated as the owner." This is similar to a spousal rollover with an IRA, and applies for both death before and after annuity starting date.</td></tr>
<tr><td>If owner dies before annuitization, spouse can keep contract in deferral.</td><td>If owner dies after annuitization, unclear if spouse can put contract back into deferral.</td></tr>
</table>

TAX UPON TRANSFER

Transfers during lifetime

Income tax. If an individual contract owner gives away a deferral-stage annuity to someone other than the owner's spouse, all the gain in the contract is immediately income taxed to the owner/donor. I.R.C. § 72(e)(4)(C). This rule prevents using death-bed gifts to circumvent the rules that require distributions after an owner's death.

Gift tax. A gift of an annuity can also trigger gift tax. The gift tax value of a deferral-stage annuity is its interpolated terminal reserve, which is generally equal to the annuity's accumulation value, but can be lower if surrender charges apply to the contract. See Comm'r v. Edwards, 135 F.2d 574 (7th Cir. 1943). The gift tax value of an annuitized contract equals the cost to buy a contract that pays the same annuity stream that remains to be paid after the gift. See Treas. Reg. § 25.2512-6(a).

Transfers at death

Income Tax. Annuities do not receive a stepped-up basis at the owner's death, and the new owner of the annuity (often but not always listed as "beneficiary") will be taxed on the gain as distributions are made. The rate of income tax will be determined by how quickly the annuity contract makes distributions. If the contract was already annuitized at the owner's death, the beneficiary's exclusion ratio depends on the payment plan at the owner's death, and whether the beneficiary adjusts those payments. If the payment plan is life-based with a refund feature (for example, life with 10 year period certain), and the beneficiary does not adjust the payments, the beneficiary first recovers all remaining basis tax free, and is taxed on any payments thereafter. See Treas. Reg. §§1.72-4(a)(4); 1.72-10(b); and 1.72-11.

Estate Tax. The gross estate includes the value of the annuity that is receivable by a beneficiary by reason of surviving the decedent. I.R.C. § 2039.

- The value of an annuity during deferral is the amount receivable by a beneficiary after death, which is usually the accumulation value, but can be higher if a "death benefit" provides a greater amount.
- The value of an annuitized contract equals the cost to buy a contract that pays the same annuity stream that remains to be paid on the date of death.

The portion of the annuity in the estate is proportionate to the premiums contributed by the decedent. If the decedent contributed only half of the premiums, then only half of the annuity's value is in the estate. Premiums contributed by the decedent's employer are deemed to have been contributed by the decedent.

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