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Taxation of Annuities

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Income taxation of annuities

Income taxation of premiums

Generally, premiums (either a single payment or monthly installments paid over the course of many years) that you pay into an annuity are nondeductible. In other words, by placing funds within an annuity, you will not receive any current income tax savings, except that earnings on the funds within the annuity will be tax deferred.

Caution: *Generally, annuity contracts have limitations, exclusions, fees and charges which can include mortality and expense charges, account fees, investment management fees, administrative fees, charges for optional benefits, holding periods, termination provisions, and terms for keeping the annuity in force. Most annuities have surrender charges that are assessed if the contract owner surrenders the annuity. Withdrawals of annuity earnings are taxed as ordinary income and may be subject to surrender charges plus a 10% federal income tax penalty if made prior to age 59½. Withdrawals reduce annuity contract benefits and values. Any guarantees are contingent on the claims-paying ability and financial strength of the issuing company. [Annuities are not guaranteed by the FDIC or any other government agency; they are not deposits of, nor are they guaranteed or endorsed by, any bank or savings association.] For variable annuities, the investment return and principal value of an investment option are not guaranteed. Variable annuity subaccounts fluctuate with changes in market conditions, thus the principal may be worth more or less than the original amount invested when the annuity is surrendered.*

Income taxation of earnings on funds within the annuity (cash value buildup)

Generally, the earnings within an annuity accumulate income-tax deferred, and the annuity owner will not be subject to income tax on such earnings until the earnings are withdrawn.

Caution: *Early withdrawals from an annuity (prior to age 59½) will not only be subject to tax, but may also trigger a federal 10 percent penalty.*

Income taxation of distributions from an annuity

Distributions (partial surrenders, full surrenders, or annuitization payments) that are categorized as earnings are treated as ordinary income for tax purposes. The income tax treatment of distributions from an annuity contract may vary based on the type of distribution method selected and date the annuity contract was entered into.

Income taxation of partial surrenders

If an annuity contract was entered into after August 13, 1982, a partial surrender of the annuity is taxed under the interest-first rule. The interest-first rule treats the partial surrender as coming from the earnings portion of the annuity first (until all the earnings have been withdrawn), not the principal. As a result, the partial surrender that is from earnings is included in the annuity holder's gross income and is fully taxable.

If an annuity contract was entered into prior to August 14, 1982, a partial surrender of the annuity is generally taxed under the cost-recovery rule. The cost-recovery rule treats the partial surrender as coming from the investment in the contract first (until all the investment in the contract has been exhausted). The remainder of the partial surrender, if any, is treated as coming from the earnings on the contract and is treated as ordinary income.

Income taxation of complete surrenders

If an annuity holder completely surrenders an annuity, the holder is subject to income tax on the untaxed earnings that are the difference between the cash surrender value of the contract and the net investment in the contract.

Example(s): *Mr. Smith owns an annuity that has a cash surrender value of $80,000 and has paid premiums equaling $30,000 into the annuity. When Mr. Smith completely surrenders the annuity, he will be subject to income tax on $50,000 ($80,000 - $30,000).*

Calculating a loss on an annuity contract

An annuity holder may suffer a loss if he or she sells or surrenders a variable annuity for less than its cost basis. This may occur if the market experiences a downturn and the value of the investment decreases.

Example(s): *Mr. Smith owns an annuity that has a cash surrender value of $80,000 and has paid premiums equaling $100,000 into the annuity. Mr. Smith completely surrenders the annuity, suffering a loss of $20,000.*

Tip: *A loss on a variable annuity is classified as an ordinary loss under Rev. Rul. 61-201, 1961-2 C.B. 46, not an investment loss reported on Schedule D. How to take the loss is an unsettled area of tax law. One approach is to take the loss as a miscellaneous itemized deduction subject to the 2 percent floor on Schedule A. Another approach is to take the loss on Form 1040, Other Gains/Losses, deducting the full loss. Consult a tax professional. Any surrender charges incurred are not considered part of the loss.*

Tip: *For a life only annuity with a starting annuitization date after July 1, 1986, a deduction may be taken for the unrecovered investment in the contract if the total of all payments received does not equal or exceed the investment in the contract.*

Caution: *Variable annuities are long-term investments suitable for retirement funding and are subject to market fluctuations and investment risk, including the possibility of loss of principal. Variable annuities are sold by prospectus, which contains information about the variable annuity, including a description of applicable fees and charges. These include, but are not limited to, mortality and expense risk charges, administrative fees, and charges for optional benefits and riders. The prospectus can be obtained from the insurance company offering the variable annuity or from your financial professional. Read it carefully before you invest.*

Income taxation of annuity payments

The tax code treats payments received as an annuity as being divided into two parts: a nontaxable portion that represents the return of the premiums paid into the annuity and a taxable portion that represents the earnings on the annuity. As a result, only a portion (i.e., the premiums paid into the annuity) is excluded from the annuity owner's gross income. The portion of each annuity payment that is excludable is determined by multiplying the number of payments received each year by an exclusion ratio. The fixed annuity exclusion ratio equals:

The annuity holder's investment in the contract (at the annuitization starting date) divided by the expected return.

Example(s): *Mr. Smith has a fixed annuity contract that pays him $200 a month for 20 years. His expected return is $200/month x 20 years x 12 months/year = $48,000. Mr. Smith has an investment in the contract of $24,000, and his exclusion ratio is $24,000/$48,000 = 50 percent. As a result, 50 percent of each $200 payment ($100) would be excludable from Mr. Smith's gross income. The rest of his payment ($100) is treated as ordinary income.*

Caution: *The rules are different for variable annuities. Since variable annuity payments fluctuate in value, it is impossible to estimate the expected return at the starting date of the annuity. Typically, 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. This calculation may vary depending on the annuitization option chosen.*

Tip: *All deferred annuity contracts issued by the same insurance company to the same policyholder during any calendar year are treated as one annuity contract.*

Section 1035 exchanges and partial exchanges

In general, under IRC Section 1035, you can exchange one annuity for another without the immediate recognition of any gain or loss. The exchange can be a complete exchange of one policy for another, or a partial exchange involving the direct transfer of a portion of funds invested in an existing annuity contract to a new annuity contract. However, to obtain this favorable tax treatment, the exchange must satisfy the requirements for a Section 1035 exchange.

Caution: *The rules governing 1035 exchanges are complex and you may incur surrender charges from your "old" annuity. In addition, you may be subject to new sales and surrender charges for the new policy.*

Income taxation when gifting an annuity

There are two ways for an annuity owner to make a gift of an annuity to another individual:

- The annuity holder can surrender the annuity and give the cash to the individual. However, this method of gifting an annuity will result in the annuity owner being subject to income tax on the untaxed earnings (the cash surrender value of the contract minus the net investment in the contract). In addition, surrendering the annuity and giving away the cash deprives the individual receiving the gift of the ability to continue accumulating tax-deferred interest within the annuity.

- The annuity owner can transfer ownership of the annuity contract to the individual. After the transfer, the annuity contract will continue to exist, with the individual receiving the annuity as the new owner. However, this method of gifting an annuity also generally has immediate tax implications for the transferor. If the transfer involves an annuity contract that was issued after April 22, 1987, the transferor of the annuity is treated as having received income equal to the difference between the cash surrender value of the contract at the time of the gift and his or her net investment in the contract.

Example(s): *Mr. Smith wishes to make a gift of an annuity to his daughter Alexandra. Mr. Smith purchased the annuity contract after April 22, 1987. He has paid $12,000 in premiums into the annuity, and the annuity has a cash surrender value of $20,000. When he gifts the annuity to his daughter, Mr. Smith will recognize taxable income of $8,000.*

The tax rules for a transfer involving an annuity issued before April 23, 1987, are a bit more complicated. The transferor of the annuity is taxed on any gains from the annuity in the year the contract was surrendered by the individual receiving the gift, not in the year when the gift was actually made.

Example(s): *Mr. Smith wishes to make a gift of an annuity to his daughter Alexandra. Mr. Smith purchased the annuity contract before April 23, 1987. He has paid $12,000 in premiums into the annuity, and the annuity has a cash surrender value of $20,000. Mr. Smith gifts the annuity to his daughter when she reaches age 21. Alexandra does not surrender the annuity until she reaches age 25. Mr. Smith would not be taxed on the gains from the annuity ($20,000 cash surrender value minus $12,000 in premiums paid into the annuity) until the year the annuity was surrendered--four years after he made the gift of the annuity to his daughter.*

Natural person requirement

Prior to 1986, the earnings within an annuity were tax deferred regardless of whether the owner of the annuity was a natural person. In 1986, Congress enacted legislation that, among other things, prevented corporations and certain entities from benefiting from the tax-deferred treatment granted to annuities. If a contribution is made to an annuity after February 28, 1986 that is owned by a corporation or other entity that is not considered to be a natural person, the earnings each year on the funds within the annuity are generally included in the owner's taxable income. However, the non-natural person rule does not apply when an annuity contract is held by a trust, corporation, or other non-natural person as an agent for a natural person. In other words, the contract will be treated as an annuity, and the earnings within the annuity will be tax deferred. In addition, it is important to keep in mind that the non-natural person rule does not apply to certain types of annuities, including any that are:

- Acquired by a person's estate at the person's death
- Held under a qualified retirement plan, a tax-sheltered annuity (TSA), or an individual retirement account
- Purchased by an employer upon the termination of a qualified retirement plan or 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 his or her beneficiary)
- An immediate annuity (i.e., an annuity purchased with a single premium that begins payments within a year of the date of the purchase of the annuity and provides for a series of substantially equal periodic payments, to be made not less frequently than annually, during the annuity period)
- A qualified funding asset (i.e., an annuity contract issued by a licensed insurance company that is purchased to fund payments for damages that result from personal physical injury or sickness)

Estate taxation of annuities

Generally, the value of an annuity contract is includable in the deceased policyowner's gross estate. If the annuity holder dies before payments begin under the contract, the value of the annuity is equal to the accumulated cash value. If payments have begun at the time of the annuity holder's death, it is the value of the remaining payments, if any, under the contract.

If the annuity is owned jointly by individuals who are not married, then the value included in the gross estate is based on each owner's respective contributions.

Example(s): *Bill paid 60 percent of the premiums on an annuity, while his cousin Ed paid the other 40 percent. When Bill dies, only 60 percent of the value of the annuity will be included in his gross estate, since he contributed 60 percent of the premiums. When Ed dies, 40 percent of the value will be included in his gross estate.*

If the joint owners are married, then half of the value is included in each spouse's gross estate.

Example(s): *Bill paid 60 percent of the premium on an annuity, and his wife, Cindy, paid the other 40 percent. When Bill dies,* *only 50 percent of the value of the contract will be included in his gross estate, even though he contributed 60 percent of the premiums. When Cindy dies, 50 percent of the value will be included in her gross estate even though she only contributed 40 percent of the premiums.*

Example(s): *However, if an annuity contract is gifted to another person by the decedent prior to death and the decedent did not retain any interest in either the contract or the annuitization payments, the value of the annuity contract generally will not be included in the decedent's estate.*

Gift taxation of annuities gifted after the annuitization starting date

If you gift an annuity, you may have to pay federal gift tax on the value of the gift. If an individual purchases an annuity and then immediately gifts the annuity to another individual, the value of the gift is considered to be the cost of the annuity contract. If the purchaser of the annuity contract holds the contract for a period of time before gifting it to another individual, and additional payments are required to keep the contract in place, determining the value of the gift is a bit more complicated. The value of the gift is equal to the sum of the interpolated terminal reserve value and the proportionate part of the most recent premium payment that covers the period extending beyond the date of death.

Tip: *The* annual gift tax exclusion *may apply.*

To schedule an appointment with Faye Sykes, click [here](#) .

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