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Annuity Tax Concepts

We have commented on a variety of annuities tax concepts as we have progressed in our review of annuities thus far. Taxation and its impact on an investment choice is a very important part of determining the suitability of an investment. Income taxes, estate taxes and gift taxes may all apply to annuities at various stages of ownership.

A. Qualified vs. Nonqualified

An annuity can be categorized as a qualified or nonqualified annuity based on the money that is used to fund it. If the dollars that are used as purchase payments are after-tax dollars, the annuity plan is nonqualified. One of the foremost benefits available to purchasers of nonqualified annuities is the tax-deferred growth opportunity that is available within an annuity [contract](#). Tax-deferred growth is of great benefit in accumulating dollars for retirement, and thus far, the government has supported the use of annuities for this purpose by imposing no limits on the amount of contributions that can be made on a nonqualified basis.

Although there are no limits imposed on contributions to nonqualified plans by the government, insurers will sometime impose limits on exceptionally high premiums for risk management purposes. Generally, these limits do not affect the typical buyer.

Qualified annuities, on the other hand, are those that are used in tax-qualified retirement plans like IRAs, Roth IRAs, 401(k), Tax-Sheltered Annuity (TSA) or 403(b) plans, defined benefit and defined contribution pension plans, Simplified Employee Pension (SEP) plans, profit-sharing plans, and certain other government plans. They are funded with pre-tax dollars. Annuities used within qualified plans provide the same investment opportunities and guarantees as those that are nonqualified. There is no additional tax-deferred treatment of earnings. The same tax-deferral is a feature of both qualified and nonqualified annuities. Annuities used within qualified plans are, however, subject to the annual contributions limits that the government has stipulated for each of the respective tax-qualified plans.

Because there are no additional tax deferral benefits, many critics have claimed that annuities should not be included within qualified plans. For the purposes of determining suitability, it should be made clear that annuities should be used as funding vehicles for qualified plans for the other benefits they provide. If value is placed on their guarantees, and other features, then they are definitely appropriate.

1. Individual Retirement Accounts

Since individual retirement accounts (IRAs) were first established by Congress in the 1970s, the total account balance has grown to hundreds of billions of dollars. What is

needed are strong creative marketing strategies designed to convince skeptics that individual retirement accounts are, and always will be, a sound and prudent path to secure retirement.

Traditional IRA

Contributions are tax-deductible, and funds grow tax-deferred, but the individual must pay taxes on those contributions and earnings when the funds are withdrawn at retirement. IRS rules mandate that minimum distributions from a traditional IRA must be taken the year after one turns age 70½. The size of those distributions depends on the IRA owner's life expectancy and spouse's/beneficiary's life expectancy.

If an individual's income is too high to contribute to a tax-deductible IRA, he or she can contribute to a nondeductible IRA. Unlike the more common IRA, contributions to this type of IRA are not tax-deductible. Nondeductible contributions and deductible contributions can be combined, although the IRS requires one to track the amount of nondeductible contributions. This is important when the required minimum distributions begin because taxes won't have to be paid on the nondeductible portion.

Roth IRA

Contributions to a Roth IRA are not tax-deductible. However, distributions from a Roth IRA are tax-free when withdrawn, as long as the individual has owned the account for at least 5 years, and the money is withdrawn after age 59½. Roth IRAs are not subject to required minimum distributions at age 70½, like traditional IRAs and other qualified plans.

If maximizing current cash flow is a priority, the individual may want to select the traditional IRA and take the deduction. On the other hand, if the deduction is not a necessity and one qualifies for a Roth IRA, it may be more beneficial to opt for the tax-free distributions at retirement. With a Roth IRA, interest compounds tax-free and money withdrawn after age 59½ is tax-free. While each person's situation should be calculated individually, the Roth IRA may yield greater income at retirement because of the tax-free compounding and tax-free withdrawals. If an individual is fortunate enough to have money in a traditional IRA and a retirement plan with an employer, those funds will be taxed at ordinary rates in retirement, leaving the individual with less income from those plan distributions.

In the event the individual has not saved enough money for retirement, he or she should consider a traditional IRA if that makes the difference between contributing or not contributing at all. Contributing to a Roth IRA makes sense because the contributions will go farther in retirement on a tax-free basis.

Contributing to a Roth IRA is better if a substantial retirement savings is available and an individual wants to leave money to his or her heirs. Using the Roth IRA, a person can designate beneficiaries, who can spread out the required distributions they must take from an inherited Roth IRA throughout their lifetimes.

The ability to contribute to a Roth IRA is phased out at higher income limits.

The table below shows the 2016 Roth IRA contribution limits and phase out.

Tax-Filing Status	Modified Adjusted Gross Income	Contribution Allowed
Married filing jointly or qualifying widower	less than \$184,000	Full deduction
	\$184,000 or more but less than \$194,000	Partial deduction

	\$194,000 or more	No deduction
Married filing separately and you lived with your spouse at any time during the year	Less than \$10,000	Partial deduction
	\$10,000 or more	No deduction
Single, head of household, or married filing separately and you did not live with your spouse at any time during the year	less than \$117,000	Full deduction
	\$117,000 or more but less than \$132,000	Partial deduction
	\$132,000 or more	No deduction

Spousal IRA

One unique feature of IRAs (traditional IRAs and Roth IRAs) is that a spouse without earned income can contribute to an IRA. In order for a spouse without earned income to establish a spousal IRA or spousal Roth IRA their spouse must have earned income sufficient to qualify for the contribution (more on this later). NOTE: In order to qualify for a spousal IRA or spousal Roth IRA you must file a joint federal tax return with your spouse. If you are married, but file separate returns the spousal IRA or Spousal Roth is not allowed.

Establishing an IRA

There are three rules that must be met in order for an individual to contribute to a traditional IRA:

- The individual (or the individual's spouse) must have earned income.
- The individual must be under the age of 70½.
- The amount contributed must not exceed \$5,500 per year for those age 49 and younger (those age 50 and older can contribute \$6,500), or 100% of compensation, whichever is less.

Earned income includes compensation for personal services, wages, tips, commissions, self-employment earnings, and even alimony. It does not include retirement income, deferred compensation, investment income or other passive income. An individual whose only source of income, for example, is dividends from inherited stock, is not eligible to open an IRA. The age limitation was established to ensure that these accounts would be used for retirement purposes, and not as a means to shelter income and earnings from taxes.

2. Qualified Plan Options for Businesses

There are three general categories of retirement plans available to small businesses. The optimum plan should reflect the company's size, financial situation, and ability to comply with regulatory oversight and administrative responsibilities.

SEP-IRAs

A Simplified Employee Pension plan (SEP-IRA) is often preferred for a single-person business or a business with just a few employees. It is relatively inexpensive and simple to establish and administer. The employer contributes to a SEP-IRA. Employees do not contribute but are immediately 100% vested, and each employee determines how their account funds are invested.

Although there are a few exceptions, a SEP-IRA plan must cover all employees age 21 or older who earn at least \$600 annually from the business and have worked for the company during at least 3 of the preceding 5 years. Currently, the annual contribution limit for each employee is 25% of compensation (or, for the self-employed, net earnings) or \$53,000, whichever is less.

SEP-IRAs also offer small business owners flexibility regarding both the amount and timing of contributions. Employers need not contribute to the plan every year and can change the percentage of the contribution at any time. As a result, a SEP-IRA may make sense for a business with profits that tend to fluctuate from year to year.

SIMPLE IRAs

The Savings Incentive Match Plan for Employees (SIMPLE IRA) is also valued for its ease of administration and is available to businesses with 100 or fewer employees. A so-called “matching” SIMPLE IRA plan currently allows employees to contribute up to \$12,500 of salary (with the catch-up provision, the limit for age 50 and older is \$15,500, or \$3,000 more).

The employer must then make a dollar-for-dollar matching contribution of up to 3% of each worker’s annual compensation. However, the employer has the right to match as little as 1% in two out of any five consecutive years.

The other method for funding a SIMPLE IRA requires the employer to make nonelective contributions equal to 2% of compensation for each worker who has earned at least \$5,000 during the year, whether or not a worker has elected to contribute income.

Employers that would like to sponsor a retirement plan but that do not want to make contributions to employees’ accounts may want to consider a 401(k). A business owner must weigh the SIMPLE IRA’s benefit of low administrative fees and the requirement of the employer match against a 401(k), which has much higher administrative fees but does not require an employer match.

Qualified Plans

Most qualified retirement plans are more complex than SEP-IRAs or SIMPLE IRAs and, therefore, have more stringent reporting requirements. Employees must be covered if they are 21 or older and have at least 1 year of service (or 2 years if the plan is not a 401(k) plan and provides for full vesting within 2 years). There are several types of qualified plans, which can be broken down into two broad categories: defined benefit and defined contribution plans.

- **Defined Benefit Plans** – Defined benefit (DB) plans are more commonly referred to as traditional pension plans. They promise to pay employees a steady income stream in retirement. The amount each employee receives is generally based on that employee’s earnings history and length of service. Employers must contribute enough to the DB plan each year to satisfy what’s known as a minimum funding requirement. Actuarial assumptions and computations are necessary to calculate benefit and minimum funding amounts. For this reason, administration of these plans usually requires professional assistance.
- **Defined Contribution Plans** – With defined contribution (DC) plans, employers make a stated contribution into individual accounts for each employee. Employees may then be given the authority to invest the money as they see fit. DC plans do not require immediate vesting and may allow employee loans.
- **Profit-Sharing Plan** – A form of DC plan, employers can vary the amount and frequency of contributions based on fluctuating profits. Profit-sharing plans have the greatest flexibility because employers can decide how much to contribute in a given year, depending upon company profits.
- **Money Purchase Plan** – Another form of DC plan, contributions are mandatory, and the percentage amount may not vary from the percentage stated in the plan documents. In other words, the employer must make contributions each and every year, whether or not the company has profits.
- **401(k) Plans** – These popular DC plans allow employee contributions (or “elective deferrals”). In recent years, 401(k)-style plans have become less complex and less

expensive for smaller businesses.

Nondiscrimination testing, filing, and administration costs can make 401(k) and Roth 401(k) plans more difficult to manage than other types of plans. (Note that SIMPLE 401(k) plans allow employers to avoid some contribution discrimination tests.) Participants may contribute up to \$18,000 for 2016, and employers also may make contributions. Total contributions to an individual's account cannot exceed \$53,000 or 100% of compensation, whichever is less.

	SEP-IRAs	SIMPLE PLANS	OTHER QUALIFIED RETIREMENT PLANS
Funding Responsibility	Employer	Employer and employee	Employer (or, for 401(k)-style plans, employer and employee)
Level of Complexity/Reporting Requirements	Low	Low	High
Vesting	Immediate	Immediate	Flexible
Contribution Limits	25% of compensation or \$53,000	\$12,500 for employees; up to 3% of compensation for employers	Varies by plan type

3. Tax-Sheltered Annuities - 403(b) Plan

Designed for **nonprofit organizations** that qualify under Section 501(c)(3) of the Internal Revenue Code, such as public schools, churches, and research organizations, 403(b) plans allow employees to voluntarily defer their compensation, subject to the same contribution limits as a 401(k) plan. These plans also known as tax-sheltered annuities (TSAs). While most schools do not match contributions, matching contributions are permitted as long as all employees are treated equally. Occasionally, an employer will offer nonmatching contributions. All full-time employees are eligible upon hire. If the employer offers this plan, there is no qualification period and both employee and employer contributions are 100% vested immediately.

B. Taxation

The distinction between qualified and nonqualified annuities is important for ongoing administration. Reporting and taxation will differ based on this status.

1. Taxation of Annuity Premiums

As has already been mentioned, annuities that are nonqualified are paid for with after-tax dollars. The dollars that are contributed are not tax **deductible**. If annuities are part of a qualified plan, the purchase payments are viewed as plan contributions, and are not includable in the employee's income when they are contributed to the annuity.

Thus, contributions to qualified annuities are considered pre-tax. The exception to this categorization occurs with Roth plans. For example, in Roth IRAs or Roth 403(b) annuities, the annuity purchase payments are includable as income.

The **exclusion ratio** is used to determine the annuity amounts to be excluded from taxes. The annuitant is able to recover the cost basis nontaxable. The cost basis is the **principal amount**, or the amount that was paid into the annuity, which is excluded from taxes. The rest of each annuity payment is interest that has been earned and is taxable.

2. Tax Deferred Growth

The growth of annuity contracts is enhanced by the deferral of taxation on any dividends, interest, and capital gains that are credited prior to withdrawals. Transfers between subaccounts and other investment options within variable annuities benefit from this favorable treatment, and are not subject to taxation when they occur. By contrast, transfers between currently taxable investments are treated as a sale and repurchase, and any gains are currently taxable. *For example*, a transfer from a mutual fund growth fund to a mutual fund balanced fund, even if within the same fund family, is considered a sale for tax purposes. Any gain or loss on that transaction is currently subject to tax reporting.

There are tremendous financial advantages to tax deferred compounding, because it allows for significant growth over time. A compounded annual return on annuity investment, after, say, 20 years could result in a tax deferred value that is equal to or even higher than the taxable value. The long-term effect of tax-deferred compounding can be thought of as "earning interest on your interest." Continuing to earn interest on funds that would have otherwise been paid in taxes enables funds to grow faster and to accumulate to a greater amount over time.

The benefit of tax-deferred growth in annuities is one that has been made available only to individuals to promote retirement savings. Annuities owned by entities such as corporations do not get the benefit of tax deferral. The entity is taxed annually at ordinary income rates on the increase in the net surrender value of the contract, minus any purchase payments that were made for that year.

3. Gifts of Annuity Contracts

Income taxes may apply when an annuity **contract** owner gives a nonqualified annuity contract to another party as a gift. If the recipient is someone other than the spouse or an ex-spouse as part of a divorce decree, the contract holder may be liable for income taxes at the time the gift is given. The amount of income that must be recognized is the difference between the cash surrender value of the contract and owner's after-tax contributions to the contract. Gift taxes may also apply to this transaction. The giver of the gift may be subject to this tax, in addition to income taxes, if the gifted amount exceeds the current annual exclusion of \$14,000 per donee (2015 amount; subject to IRS announced inflation increases).

4. Withdrawals

Annuity **contract** owners may be subject to income taxation when they take lump-sum withdrawals. Because the money within the contract accumulated on a tax-deferred basis, income taxes are due on any contract earnings. Capital gains rates never apply to annuities (both qualified or nonqualified), so all earnings withdrawn from any annuity are always taxable as ordinary income.

In addition to income taxes, a further 10% federal tax penalty applies on the taxable amount of earnings withdrawn, if taken before the age of 59½. Taxation is in addition to any surrender charges that may apply.

When a partial withdrawal is taken from a nonqualified annuity, the earnings are determined using the *interest and earnings first* method.

To illustrate, assume that the owner of a nonqualified contract funded it with \$60,000 in after-tax money. Years later, the contract value is \$100,000, comprised of the \$60,000 in after-tax contributions and \$40,000 in earnings, which has not yet been taxed due to tax deferral. Now the 65-year-old owner takes a partial withdrawal of \$35,000. The *interest and earnings first* method assumes the first dollars withdrawn in a partial withdrawal are earnings (until all earnings have been withdrawn). The entire \$35,000 of the partial withdrawal is considered earnings and is taxable as ordinary income in the year withdrawn. Partial withdrawals are considered earnings as long as earnings remain in the contract.

If the above example were changed slightly and the partial withdrawal was \$45,000, there would have been \$40,000 taxed as earnings and \$5,000 would have been attributed to after-tax contributions and not taxable.

For qualified contracts, all contributions are made with pre-tax dollars, so any withdrawal is subject to full taxation as ordinary income. The 10% federal tax penalty also applies if the withdrawal is taken before age 59½.

Example:

Ellen has contributed \$48,000 to a nonqualified deferred annuity. It has earned \$48,000 in interest for a total current value of \$96,000. It is time for Ellen to begin receiving distribution payments from the annuity, but she is confused about the tax effects.

Each payment Ellen receives is made up of both principal and interest. Because nonqualified annuities are paid for with after-tax dollars, the portion of the payment that is attributable to after-tax contributions will not be taxed. The portion of the payment that is attributable to interest or earnings will be taxed as ordinary income. This is calculated using the **exclusion ratio**. The exclusion ratio benefits Ellen because it spreads her tax liability over the years she is receiving payments from the annuity.

If Ellen's annuity is set up to make distribution payments for 10 years, she will receive \$800 per month for 10 years (\$96,000/10 years/12 months). Fifty percent of each payment is principal, so \$400 is received with no tax consequences. The other \$400 is interest and taxed as ordinary income.

5. Assignments of Annuity Contracts

Assignments of annuity contracts are taxed like partial withdrawals. Any amount of an annuity contract's cash value that is assigned or pledged as collateral is subject to the income tax treatment just described. The portion attributable to earnings is withdrawn first and subject to income taxation.

6. Contract Surrenders

If an annuity owner surrenders a nonqualified contract in its entirety, income taxes are due at ordinary income tax rates on the earnings portion of the amount received. The earnings portion is the difference between the after-tax contributions made to the annuity and the amount that is received when surrendered. While there are limited

exceptions, the IRS 10% penalty will also apply to the earnings portion received when surrendered if the surrender occurs prior to the age of 59½.

Please note: **The IRS 10% penalty does not apply to amounts distributed from a nonqualified annuity that are attributable to after-tax contributions;** however, since contributions made to a qualified annuity (such as an IRA or 401(k)) are made with pre-tax dollars, all amounts distributed are considered earnings and therefore subject to the 10% IRS penalty if withdrawn prior to 59½.

7. Premature Distributions

Most premature distributions are subject to the 10% federal tax penalty that applies to withdrawals or complete [contract](#) surrenders that occur prior to the age of 59½. However, exceptions may apply. There is no tax if the distribution is made due to the owner's death or disability.

8. Taxation of Annuity Payments

Unlike partial withdrawals from a nonqualified annuity, distributions that are made pursuant to the election of an annuitization method (single life, joint life, period certain, etc.) are taxed using a calculation involving the exclusion ratio. Each payment is treated as part of a return of after-tax contributions and part earnings. The amount attributable to earnings is subject to taxation as income, and considered a return of after-tax contributions (also called principal or cost basis), so it is not taxed.

To determine the amount of principal returned in each annuity payment, the total principal that was contributed is divided by the amount of each annuity payment multiplied by the number of expected payments specified by the annuitization method elected (called the expected return). The ratio of the total principal contributed divided by the expected return is called the **exclusion ratio**, and is applied to each annuity payment to determine the amount excluded from taxation as a return of principal.

When annuity payments are to be made for life, determination of the expected return is based on the life expectancy of the annuitant.

For example, let's assume that over a number of years an individual had contributed \$85,000 in after-tax money to a nonqualified deferred annuity, and at age 70 elected a life-only annuitization that will pay \$1,000 a month in annuity payments. Let's further assume that the IRS mortality table indicated a 10-year life expectancy for a 70-year-old individual. The expected return would be \$120,000 (\$12,000 per year of annuity payments times a life expectancy of 10 years). In the first year of annuitization, the exclusion ratio would be .70834, which is calculated by dividing the after-tax premiums contributed by the expected return (\$85,000/\$120,000). Using this exclusion ratio, \$8,500 would be excluded from taxable income as a return of after-tax premiums paid into the annuity (\$12,000 in annuity payments X the exclusion ratio of .70834).

If you add in inflation riders or period certain, the calculation is more complicated. In addition, the expected return and exclusion ratio must be recalculated every year. The good news is that the burden of calculating the taxable and nontaxable amount of each year's annuity payments is placed on the annuity company. Each year the monies are paid out of an annuity, the annuity company must file a 1099R with the IRS and send a copy to the annuitant.

At times, annuity [contract](#) owners may choose partial annuitization, which means only a portion of the contract's cash value is used to produce annuity payments. When this

is the case, the contract is segmented into two parts. The part that is not annuitized is not subject to any tax consequences. The after-tax payments into the contract are allocated pro-rata between the two contract segments for determining the exclusion amount of each payment.

9. Taxation Rules at Death of the Owner

When the owner of an annuity dies, certain distributions must take place by law. This requirement helps prevent prolonged deferral of the income tax that applies to the gains in the [contract](#). If the owner dies before the commencement of annuity payments, tax rules require that the entire contract interest is distributed within 5 years of the date of the owner's death.

The [beneficiary](#) of the contract has the following choices:

- Take the full amount and pay all taxes at that time;
- Take withdrawals over the next 5 years and pay the taxes due on each withdrawal, as the remaining amount within the account continues to grow on a tax-deferred basis;
- Wait for the full 5 years to take the withdrawal, and allow it to grow tax deferred until that time. All taxes must be paid at the time of the withdrawal.

An exception to the 5-year distribution requirement may apply when payments are made to a beneficiary over life or for life expectancy. The beneficiary has 12 months from the date of the owner's death to choose to invoke either of these options. If the beneficiary selects the life option, each payment is treated as part return of principal, part earnings as described previously.

If the individual who died had a spousal beneficiary, the rules are slightly different. The surviving spouse is treated as the owner of the contract, and the after-death distribution rules are postponed until the surviving spouse's death.

If the owner dies on or after the annuity commencement date, but before the entire contract interest is distributed, the remaining portion must be distributed at least as rapidly as the distribution method that was in effect at death. For example, if the annuity owner died 10 years into a 20-year period certain, the remaining amount must be distributed over a period not to exceed 10 years.

10. Estate Tax Concepts

Although annuities are designed as retirement planning contracts, not estate planning tools, they do have some benefits that apply to estate tax situations. Annuities avoid probate and offer some benefits that can result in preservation of the value of the estate.

The probate process can be costly, long, and drawn out. Because annuities require the naming of a [beneficiary](#), the probate process can be avoided. Payout of the benefit is direct to the beneficiary.

An exception to this practice exists if the annuity owner named the estate as the beneficiary, did not name the beneficiary, or if the beneficiary rejected the benefit and there was no contingent beneficiary. In any of these examples, the proceeds are considered part of the estate, subject to its normal distribution process.

Annuity contracts offer a unique provision known as a "restricted beneficiary" option. This provision allows the annuity owner to specify the amount, frequency and timing of distributions to be paid to a beneficiary. The annuity will pay the benefit over the life of the beneficiary, during which the contract proceeds can continue to grow and

compound on a tax-deferred basis. The insurer must have the necessary paperwork completed by the owner for this type of distribution.

Most annuity products include death benefits that ensure that beneficiaries will receive no less than the original purchase amount minus any withdrawals. Enhanced benefits options sometimes increase the death benefit based on positive investment performance. When the beneficiaries receive the death benefit, they must typically recognize the earnings portion of the death benefit payout as income, and pay taxes on that amount. **The amount that is considered a return of principal is not taxable to the beneficiary.**

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