Guide to Non-Qualified Annuities

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I. Introduction

This writing is a general overview of non-qualified annuities and how they are taxed under federal income tax rules and regulations. However, it is important to note that although the income tax rules are universally applied to all annuities, not all annuities are the same. How an annuity "behaves" depends on the individual contract language.

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This outline has six parts.

II. Overview of Non-Qualified Annuities

Although annuities are not actually defined in either the Internal Revenue Code (IRC) or United States Treasury Regulations, the taxation and operation of annuities is governed largely by these documents. In the broadest sense, an annuity is a contract between an insurance company and an owner that guarantees payments to the owner for a specified period of time in return for either a single premium payment or periodic flexible premium payments to the insurance company.[1] An annuity liquidates a sum of money over the annuity period.

A. "Owner-Driven" and "Annuitant-Driven" Contracts

Every annuity contract must conform to IRC §72(s)(1). This section requires all annuity contracts to make complete distributions when any holder dies ("holder" is another term for "owner"). Such contracts are sometimes referred to as "owner-driven." In general terms, an owner's death triggers the contract's death distribution requirements.

Some contracts contain additional language requiring them to distribute all their money when an annuitant dies. Such contracts are sometimes referred to as "annuitant-driven." Although these contracts still distribute all their money at an owner's death (because IRC §72(s)(1) requires this), they also must do so at an annuitant's death. Therefore, in general terms, an annuitant-driven contract will distribute all its money when an owner or annuitant dies.

In this discussion, we will refer to "owner-driven" and "annuitant-driven" annuities as we have described those terms above. However, there is no agreement in the industry on a precise definition for either term. As a result, you cannot predict a contract's death distribution

[1] Treasury Regulations state that an annuity, to receive the tax-favorable treatment under IRC §72, must be an annuity issued by a commercial life insurance company. It must be considered an annuity in accordance with the customary practice of life insurance companies. Reg. §1.72–2(a)(1). In practice, most annuities sold in the United States satisfy this requirement because state insurance departments approve their sale.

requirements simply by classifying it as “owner-driven” or “annuitant-driven.” In every case, you must read the contract to determine ownership rights and the terms of distributions from the contract.

For example, may the owner in an owner-driven contract change the annuitant during the accumulation phase, and if so, under what circumstances? Not all annuity contracts give the same answer to that question.

B. Parties to an Annuity

1. Annuitant

The annuitant is the person whose age and, when appropriate, gender the insurance company will use to determine the amount of the annuity payments if the annuity is annuitized. The annuitant is always an individual. It is never a trust, corporation, partnership, etc. Annuity payments need not be paid to the annuitant. The owner and annuitant are often the same person.

There is only one “primary annuitant.” It is usually the first annuitant named.

If there is a joint annuitant, it is usually the annuitant’s spouse. Naming a joint annuitant provides a way to ensure that income is available for as long as either party is living.

2. The Beneficiary

The beneficiary of an annuity contract is generally the person or entity entitled to receive any payments due after the owner dies. The beneficiary becomes the new owner but has limited rights, typically only the right to decide how moneys due should be paid. If the original owner does not name a beneficiary, the death benefit usually passes directly to the owner’s estate. As previously stated, it is important to review the contract language to determine the beneficiary’s rights at the owner or annuitant’s death.

If the payee dies during the payout phase, the insurance company pays any remaining annuity payments to the beneficiary.

If the beneficiary dies before the owner dies, the annuity is not affected. The owner, however, should name a new beneficiary. The owner may name more than one person or entity as a beneficiary. Joint beneficiaries share in any survivor benefits when the owner dies.

3. Contingent Beneficiary

The contingent beneficiary’s interest in an annuity depends on the annuity contract. The contingent beneficiary stands in line behind other beneficiaries, and receives payment, if and only if, the primary beneficiary dies before the owner.

4. Life Insurance Company

Life Insurance Company (Insurance Company) is the commercial life insurance company that issues the annuity.[2]

5. Owner

The owner (annuity owner) is the person(s) or entity entitled to receive distributions from the annuity, either before or after annuitization. The owner has all the rights to the contract

[2] Reg. §1.72–2(a)(1)

and pays the premiums.[3] Depending on the contract language, these rights may include the right to:

- Terminate the annuity,
- Gift it to someone else,
- Withdraw money from it,
- Name or change the beneficiary,
- Begin and change systematic withdrawals,
- Change ownership by naming someone else as owner,
- Add a joint owner,
- Name or change an existing beneficiary, joint beneficiary or contingent beneficiary,
- Name the annuitant and joint annuitant. Some annuities do not allow the owner to change the annuitant. Annuities issued by the Genworth Financial companies do not allow the owner to change the annuitant after the annuity has been issued.
- Pay additional premiums, if allowed,
- Annuitize the contract, or
- Change the selected subaccounts for new deferred variable annuity premiums and reallocate existing premiums within the annuity.

The owner of the contract may be a person or non-living entity such as a trust or charitable organization. The owner generally must include in gross income any taxable income received from the annuity – even if someone else receives the check (i.e. a designated payee).

More than one person or entity may own an annuity. In most cases, joint owners share ownership of the annuity equally.

Joint ownership of an annuity is not like joint ownership of a checking account. If Mom and Dad are joint owners of a checking account, *either* of them can take money out of the account without the other having to sign the check. If they want to take money out of a jointly owned annuity, they must *both* sign the paperwork.

6. Payee

The payee is the person or entity the owner selects to receive annuity payments after the contract is annuitized. Most often, the owner selects himself or herself as the payee, but some annuities may require that the payee be the annuitant.

Comment There is a distinction between a beneficiary and a payee. A payee's rights exist only during the annuitization period and end when the owner dies. A beneficiary receives the death benefits under the annuity payable when the owner dies before the annuity matures. The beneficiary also receives any remaining annuity payments, such as those payable under a period certain provision or refund option, upon the death of the owner.

C. Other Definitions

Here are some more terms you will run into when dealing with annuities.

[3] Tax laws often refer to the "holder" of the annuity. Legislative history defines a "holder" as the party who exercises annuity ownership rights. Staff of the Joint Committee on Taxation, 98th Cong., 2d Sess., *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984,* at 659 (Comm. Print) ("DEFRA Bluebook")

1. **Accumulation Phase**

The accumulation phase is the period during which premiums remain within the annuity, growing on a tax-deferred basis until they are withdrawn. The accumulation phase begins once the insurance company receives a premium.

2. **Annuitization**

Annuitization (annuity payments, income payments or payout phase) refers to the periodic payments the insurance company makes during the annuity period that liquidate both the investment in the contract and earnings by the end of the annuity period. Tax law describes these as "amounts received as an annuity."[4] They constitute the payout phase of the annuity. Tax law refers to all other distributions from the annuity as withdrawals or as "amounts not received as an annuity."[5] The annuitization (payout) phase begins when the owner turns over the annuity value to the insurance company in exchange for an income stream. Annuitization is usually an irrevocable decision.

3. **Annuity Period**

The annuity period is the period during which the insurance company makes annuity payments. Annuity payments are made on a regular basis (usually annually, semi-annually, quarterly, or monthly) during the annuity period. The annuity period is generally based on the lives of one or more people but may also be for a specified duration or a combination of lives and periods of time.

4. **Annuity Value**

The annuity value (contract value, cash value or account value) is the value of the annuity on any given date minus charges such as premium tax, annual contract charges, and optional benefit charges.[6] The annuity value for most tax purposes is determined *before* surrender charges.[7]

5. **Basis**

Basis (Investment in the Contract) is generally all the premiums (or other consideration) paid for the annuity minus all non-taxable distributions from the annuity before annuity payments begin.[8] Unless indicated otherwise, we use the terms "basis" and "investment in the contract" interchangeably. Basis is important because it is used to determine the income tax consequences of withdrawals from the annuity. Basis may have to be adjusted for a number of items.[9]

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[4] IRC §72(a)
[5] IRC §72(e)
[6] In a variable annuity, this is usually the same as the total value of the guarantee account and all separate account subaccounts. In a fixed annuity, it is the guaranteed value.
[7] IRC §72(e)(3)(A)(i)
[8] IRC §72(c)(1) defines basis for annuity payments. You must determine the "aggregate amount of premiums or other consideration paid" as of the later of the annuity's maturity date or the date the first payment is made after annuitization. This is called the "Determination Date." *See*, Reg. §1.72–6(a)(1). Then subtract any non-taxable annuity distributions and all premium returns or dividends received (including unpaid loans or dividends applied against those loans or related interest) before the Determination Date. The following items do not reduce aggregate premiums: Excludible dividends left on deposit to accumulate at interest where the dividends and interest are used to produce larger annuity payments, terminal dividends used to increase annuity payments and dividends used to buy paid up additional insurance if the annuity payments include income from the paid-up additions. IRC §72(e)(6) defines basis when distributions are not annuity payments. IRC §72(c)(1) defines basis in a similar, but not identical, manner.
[9] Extra premiums paid for disability waiver of premiums, double indemnity, disability income, and other riders on non-qualified annuities are not included in basis. Premiums waived because of disability do not increase basis. Rev. Rul. 55–349, 1955–1 C.B. 232. *Compare Estate of Wong Wing Non v. Comm'r,* 18 T.C. 205 (1952) *Wong* is the only case dealing with this issue and

6. Death Benefit

Death Benefit is the benefit the insurance company pays on the death of an annuitant before the annuity enters the payout phase. In general, during the accumulation phase of an owner-driven annuity, the death of an annuitant does not necessarily require a distribution of that benefit – it may remain in the annuity. However, you must consult the annuity's contract language to make sure that this general statement holds true for the particular annuity under consideration.

7. Distributions

Distributions (or withdrawals) refer to money taken out of an annuity by the owner – usually but not always – during the accumulation phase. The term "annuity payments" is normally used when referring to money paid out during the payout phase. Withdrawals may be either taxable or non-taxable.

8. Internal Revenue Code

Internal Revenue Code (IRC, Code or Tax Law) refers to the 1986 Code, as amended.

9. Maturity Date

Maturity date (annuitization date, start date or annuity commencement date) is the date when the insurance company must begin (or does begin) making annuity payments. It marks the end of the accumulation phase and the beginning of the payout phase.

10. Natural Person

A natural person is a living person. It is *not* a corporation, trust, partnership, charity, etc. The IRS considers these to be non-natural persons. We sometimes refer to non-natural persons as non-natural owners. A non-natural owner may act as the agent for a natural person.

11. Premium

Premium (purchase payment or investment) is money or other consideration the owner puts into the annuity.

12. TEFRA

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA)[10] created a dividing line for determining annuity taxation. Annuities bought before August 14, 1982, are commonly called pre-TEFRA annuities. Those bought on or after that date are post-TEFRA annuities. For non-annuitized distributions, pre-TEFRA annuities allow the owner to withdraw basis before taking taxable earnings out of the annuity. Post-TEFRA annuities require that taxable earnings be withdrawn first.

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involved computing gain for a matured endowment contract. *Compare, Moseley v. Comm'r*, 72 T.C. 183 (1979). If premiums are deposited in advance (and appropriately discounted), only the amount actually paid is added to basis. Increments in the advance premium fund, to the extent included in gross income, can be added to the discounted premiums in determining basis. *See* Rev. Rul. 65–199, 1965–2 C.B. 20. Adjustments must also be made when the annuity promises a minimum period of payments certain. See various subsections of Reg. §1.72–7. Basis may have to be allocated to annuity subaccounts or calculated using special rules. For example, you must make an adjustment if a life contingent annuity has a refund of premium feature, including payments for a period certain, or provides joint and survivor payments. Policy loans are taxed under IRC §72(e)(4)(A).

[10] Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Pub. L. No. 97–248.

D. Qualified vs. Non-Qualified Annuities

1. Qualified Annuity

Qualified annuities include annuities written or endorsed as individual retirement annuities (IRAs), Roth IRAs, SIMPLE IRAs, Simplified Employee Pensions (SEP) and 403(b) annuities – tax sheltered (TSA) or tax deferred annuities (TDA) – or as qualified retirement plan investments. There are limits to how much one may contribute to a qualified annuity in any given year.

2. Non-Qualified Annuity

A non-qualified annuity is any annuity that is not a qualified annuity. There are no legal limits to how much one may contribute to a non-qualified annuity. However, most insurance companies limit how much one individual may invest in annuities with them.

E. Types of Annuities

The life insurance industry categorizes annuities according to features such as the frequency of premiums or annuity payments, the method for determining annuity payments, and the tax status of the annuity.

1. Single Premium Immediate Annuity (SPIA)

With a single premium immediate annuity, the insurance company receives a single premium and begins making annuity payments within one year. The annuity payments can be structured in many ways, but are often set up to pay a systematic income for the rest of the owner’s life.

When buying a SPIA, the owner pays a premium in exchange for the insurance company’s promise of a guaranteed stream of income. Generally, once a SPIA is paid for and is beyond the “free look” period, it is a binding contract and the owner may not change either the annuitant or the payment period.

In calculating the amount of income it will guarantee, an insurance company considers:

- The future investment return it expects to receive from the single premium,
- The annuitant’s life expectancy, and
- The income distribution option the annuitant selects.

Some insurance companies offer “rated-age” SPIAs. These annuities consider the annuitant’s health when determining the amount of income that will be paid for a specific premium. In essence, the insurance company underwrites these annuities and, if the annuitant’s health indicates a shortened life expectancy, adjusts the payments upwards based on that life expectancy.

2. Deferred Annuity

A deferred annuity is a contract between an individual and an insurance company, bought with one or more payments. Annuity payments begin more than one year after the insurance company issues the deferred annuity.

A deferred annuity begins in the accumulation phase and may continue in that phase for many years. It may later change to the payout phase. Interest and other earnings are income tax-deferred as long as they remain in the annuity. The earnings rate may be fixed, variable, or indexed. Deferred annuities usually have a cash surrender value and provide a death benefit.

a. Deferred Annuities Categorized by Premium Payments

(1) Single Premium Deferred Annuity (SPDA)

An SPDA is paid for with a single lump sum premium. Annuity payments to the payee must begin more than one year after that purchase. Annuity payments are deferred until the maturity date. Before the maturity date, the annuity is in the accumulation phase.

With an SPDA, the owner usually may not pay additional premiums into that same annuity after the first premium. If additional contributions are desired, the owner must buy a new annuity. Some SPDAs, however, do allow additional premiums in the first year or two.

(2) Flexible Premium Deferred Annuity (FPDA)

An FPDA allows the owner to make periodic premium payments, usually at the owner’s discretion. Annuity payments are deferred until the maturity date, which is generally at least one year beyond the issuance of the contract but may be many years out.

b. Deferred Annuities Categorized by Investments

(1) Fixed Annuity

With a fixed annuity, the insurance company pays a fixed rate of return that cannot fall below a stated guaranteed minimum rate during the accumulation phase. It frequently provides a fixed benefit after the annuity’s maturity date. The insurance company invests the premiums, less any applicable premium taxes and other charges, in the insurance company’s general account and manages those investments to meet its obligation. Typically, a fixed annuity involves little risk to the owner’s principal because the insurance company guarantees the return of principal. The primary risks are that the insurance company will be unable to meet its obligations (insurer risk) and that the rate of return will be too low for the owner to meet his or her financial objectives.

(2) Variable Annuity

A variable annuity allows the annuity owner to select how the premiums, less any applicable charges, will be invested. The net premiums are invested in separate accounts (subaccounts) selected by the annuity owner and are kept segregated from the insurance company’s general account assets. The investment accounts, also known as subaccounts, usually range from conservative to aggressive investment options.

Some variable annuities may offer minimum guarantees which offer downside investment protection and upside investment potential from the subaccounts. Unlike fixed annuities, which guarantee principal and interest, variable annuity subaccount values and returns generally fluctuate. The only exception is a fixed rate account, which gives the owner a fixed rate guarantee for a specified period. Many variable annuities do not offer a guaranteed rate of return.

Variable annuities are designed as long-term investments. The annuity value during the accumulation phase depends on the current value of the investment units in the subaccounts. At annuitization, however, the annuity payments may be based on either the separate account value or the separate account units may be liquidated to provide a fixed retirement income.

Because of the investment and principal risk associated with variable annuities, they are deemed to be securities by the Securities and Exchange Commission (SEC). The SEC requires that a prospectus accompany all sales of variable annuities. Only individuals licensed to sell securities may discuss or offer variable annuities to their clients.

(3) Equity-Indexed Annuity

An equity-indexed annuity is a type of fixed annuity that guarantees a minimum fixed return combined with the possibility of earning higher returns linked to the performance of an equity index.

The insurance company pays interest based on the performance of the index. An equity-indexed annuity will usually guarantee a minimum rate of return on principal. An equity-indexed annuity lets a conservative investor participate in the potentially higher returns provided by the stock market without taking the normal downside risk. Although the equity-indexed annuity has some similarities to a variable annuity, they are currently not considered securities.

F. Distribution Options

Annuity owners can elect to access the contract values through a number of ways, ranging from a complete surrender (lump sum distribution) of the contract to annuitizing the contract over the annuitant's lifetime. However, not all distributions are treated the same under the Internal Revenue Code.

1. Amounts Not Received as an Annuity

These distributions include:

- Cash withdrawals,
- A partial or complete surrender of the annuity,
- Policy dividends,
- Death benefits,
- Guaranteed lump sum refunds from a refund life annuity settlement,[11]
- Distributions of interest only,[12]
- Loans in which the annuity is collateral for the loan[13], and
- Any other distributions that are not part of the systematic liquidation of a principal sum.[14]

2. Distributions After Annuitization (Amounts Received as an Annuity)

Amounts received as an annuity refers to distributions after traditional annuitization. It includes all annuity payments resulting from the systematic liquidation of a principal sum by the end of the annuity period. It refers not only to payments made over life expectancy, but also to other distributions such as payments under a fixed period or a fixed amount settlement option.[15]

When annuitizing the contract, the amount of the annuity payments will be based on:

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[11] Reg. §1.72–11
[12] Rev. Rul. 75–255, 1975–2 C.B. 22
[13] IRC §72(e)(4)(A)(ii)
[14] *See* IRC §72(j) ; Reg. §1.72-14(a)
[15] Reg. §§1.72–1(b) and 1.72–2(b)

- The annuity value on the start date,
- The annuitant’s life expectancy based on age and gender,
- The annuitization option selected, and
- The insurance company’s estimate of its future earnings and expenses.

During the payout phase of the annuity, the owner may typically choose from several annuitization options.

a. Life Only Income Payments

Life only income payments continue as long as the annuitant lives and stop when the annuitant dies, regardless of when death occurs. If the annuitant lives only a short time after the start of the annuity payments, no further payments are made. If, on the other hand, the annuitant lives a very long life, the payments will continue until death, even if the total amount paid far exceeds the accumulation value of the annuity when payments began.

b. Life Income with Installment or Cash Refund

The Life Income with Installment or Cash Refund option will also pay for the entire life of the annuitant. However, if the annuitant dies before an amount equal to the accumulation value immediately prior to annuitization has been paid, an installment or cash refund may be paid. The installment or cash refund will equal the accumulation value immediately before annuitization less the value of the annuity payments made to the date of death. Depending on the terms of the annuity or the annuitization method chosen, the refund amount might be paid in installments or as a lump sum to the payee.

c. Life Income with Period Certain

Life Income with Period Certain also pays the annuity amount for the entire life of the annuitant. However, under this option a guaranteed period is selected that ensures continued payment for the balance of the specified period if the annuitant dies early. For example, assume the owner selected annuity payments to be paid for life with a 20-year period certain. If the annuitant lives for 30 more years or longer, payments will continue. However, if the annuitant dies in year 12 of the payout phase, payments will continue for another 8 years before stopping.

d. Joint and Survivor Life Income Option

The selection of a Joint and Survivor Life Income Option allows payments to continue for the lives of two annuitants, guaranteeing payments until both have died. Depending on the options selected or the terms of the annuity contract, the benefit might be reduced following the death of the first annuitant. Examples of these reductions include a joint and one-half option, where the benefit declines by one-half at the first death, or a joint and two-thirds option, where, similarly, the payments go down by one-third. Other options for reductions may be available as well. In addition, depending on the individual annuity, a reduction may be triggered not by the death of the first annuitant, but only by the death of the primary annuitant.

Under most annuity contracts, period certain and other refund options are also available with a joint and survivor life income option.

e. Period Certain

A Period Certain option liquidates the annuity value over a specified period. At the end of that period, all payments end.

f. Fixed Amount

Fixed Amount options allow the owner to select the dollar amount that will be paid. Payments are fixed, but how long the annuity is paid out depends on the annuity value when payments begin.

3. Distributions When a Party to the Annuity Dies

See the discussion below in Section VII beginning on page 26.

G. Riders

An annuity benefit rider is generally an amendment to an annuity contract that expands benefits or provides additional benefits beyond those found in the base contract. In recent years, benefit riders have increased in popularity, especially with variable annuity contracts. "Living benefit" riders generally provide benefits to the annuity owner during lifetime, whereas "death benefit" riders provide additional death benefits. Below are descriptions of some popular riders.

1. Guaranteed Minimum Withdrawal Benefit (GMWB) Riders

"Guaranteed Minimum Withdrawal Benefit"(GMWB) riders are "living benefit" riders that generally guarantee the return of principal over a period of time, subject to a pre-specified guaranteed withdrawal rate. If the rider has a guaranteed withdrawal for life feature, it may be called a Guaranteed Minimum Withdrawal Benefit for Life (GWLB). With the GWLB, the rider may promise to continue to pay an amount equal to a specified "annual withdrawal amount percentage" every year until the death of the annuitant (or until the death of the surviving spouse in case of a joint life rider) even if the contract value falls to zero as a result of withdrawals or investment downturns.

2. Guaranteed Minimum Annual Benefit (GMAB) Riders

"Guaranteed Minimum Annual Benefit (GMAB) riders guarantee that the policy surrender value will be a minimum amount at a given point in time (for example, account value may be guaranteed at the end of 10 years to be at least equal to the premiums paid less withdrawals)

3. Guaranteed Minimum Income Benefit (GMIB) Riders

"Guaranteed Minimum Income Benefit" (GMIB) riders guarantee a minimum value for annuitization, often based upon the initial principal accumulated at a specified rate of interest, a potential periodic ratchet in value if applicable, or some combination. The minimum value is then converted into a payout annuity at a guaranteed purchase rate.

4. Rollup Death Benefit Riders

"Rollup Death Benefit" riders generally provide a death benefit that increases periodically by a specified percentage until the benefit is equal to a multiple (usually two times) of the original purchase payments. Withdrawals may reduce the death benefit on a dollar for dollar or a pro rata basis. The benefit is payable upon the death of the annuitant or contract owner.

5. Step-Up Death Benefit Riders

"Step-Up Death Benefit" riders usually "step-up" the death benefit to the highest account value at certain intervals to protect the death beneficiaries against possible losses in the variable annuity in a down market.

III. Structuring the Annuity to Meet the Customer's Needs

Warning Mistakes made in designating the owner and annuitant may result in unwanted tax consequences, undesired distributions, and, possibly, the loss of a death benefit.

Most customers want their annuity set up so the result is the least amount of income tax payable when the annuity ends (and distributions are made) while at the same time providing the maximum flexibility for those distributions. Often, they want to preserve any rights that a surviving spouse has to continue the annuity. To help understand the importance of how an annuity is set up, let us look at several examples. In considering these examples, remember that contract language may differ among annuity contracts, and therefore the results under different contracts may differ from these examples, even using identical facts. It is important to read the contract.

Example 1. Spouses Jointly Own Annuity and One Dies

Annuitant:	Wife
Owner:	Husband & Wife, jointly
Beneficiary:	Child

Wife dies before the annuity maturity date. Since Wife was both a joint owner and the annuitant, two things occur. First, the death of either owner triggers the termination and the mandatory distribution of the annuity. Second, the death of the annuitant under this contract will typically set the surrender value equal to the death benefit provided in the annuity. However, since Husband is a co-owner of the annuity, he may become the annuitant and continue the annuity as the sole owner under the spousal continuation rules, annuitize the contract *or* take the death benefit. If he takes the death benefit, he will pay income tax on the annuity's gain

Query Did Wife expect Child, as beneficiary, to get the money if she died?

Example 2. Annuitant Dies, Spouse is Owner

Annuitant:	Husband
Owner:	Wife
Beneficiary:	Child

Husband dies before the annuity maturity date. Because Husband was the annuitant, the surrender value is reset to the death benefit. The annuity continues. Wife is still the owner and she becomes the annuitant.

Query Were the parents expecting Child to get money when either parent died?

Example 3. Owner Dies, Spouse is Annuitant

Annuitant:	Wife
Owner:	Husband
Beneficiary:	Child

Husband dies before the annuity maturity date. Because Husband is the owner, the annuity ends when he dies. Child becomes the owner, but may not continue the annuity. Child may only choose between (1) annuitizing the death proceeds over either the Child's life or a period of years not exceeding the Child's life expectancy, (2) taking a non-annuitized 'stretch" of the death proceeds with minimum annual distributions based on the Child's life expectancy, (3) taking the death proceeds as a lump sum distribution, or (4) taking the death proceeds over a five-year period.' Because the death of the owner is one of the exceptions to the 10% penalty tax, Child will have to pay income tax on any gain in the contract, but will not have to pay the 10% penalty tax for distributions made before age 59½.

Query Did Husband and Wife know that the owner's death would trigger a payment to Child? Were they expecting that the Wife would be able to continue the annuity?

Example 4. Annuitant of Trust-Owned Annuity Dies

Annuitant:	Husband
Owner:	Trust
Beneficiary:	Trust

Husband dies. The trust may take the death benefit or defer distribution for as long as five years. It may *not* take annuity payments over the lifetime of the trust beneficiaries nor may it continue the annuity by naming a new annuitant. When a non-natural person owns an annuity, the death of the annuitant triggers a mandatory distribution. Unless the trust distributes proceeds in the year it receives them, it pays tax on the taxable portion of the payment at the trust's income tax rates. Those rates may be higher than the individual trust beneficiary's tax rates.

Example 5. Beneficiary Dies

Annuitant:	Husband
Owner:	Husband
Beneficiary:	Wife

If the beneficiary dies, Husband simply names new beneficiaries, and maintains control over the annuity as owner.

Example 6. Spousal Owner Dies; Surviving Spouse as Sole Beneficiary

Annuitant:	Husband
Owner:	Husband
Beneficiary:	Wife

Although the death of the annuity owner generally triggers a mandatory distribution, if Wife is the sole beneficiary to an annuity owned by Husband, Wife may exercise her spousal continuation rights and continue the annuity as the new owner. Wife becomes the annuitant and may name a new beneficiary. She may choose to make additional contributions, take withdrawals, annuitize or surrender the annuity.

IV. Overview of the Income Taxation of Non-Qualified Annuities

A. IRC §72 Generally Governs Taxation of Annuities

The many rules that apply to annuity taxation can be confusing. Created over many years, the rules often reflected competing or conflicting concerns of legislators or regulators. During the late 1970's and early 1980's, annuities were being used to avoid taxes in ways that Congress perceived as abusive. These uses were not in keeping with Congress' original intent to encourage retirement savings by giving annuities preferential tax treatment.[16] Beginning in 1982, Congress continually amended the tax laws to emphasize the retirement purpose of annuities. These changes led to a somewhat disjointed set of annuity tax laws.

Annuities are subject to many tax laws although they are generally taxed under IRC §72. Those rules apply in taxing both annuity payments and other distributions from both SPIAs and deferred annuities.[17] Some payments that might appear to be subject to IRC §72 rules are not.

[16] *See* Tax Reform Act of 1986, Pub. L. No. 99–514, TRA '86 Senate Explanation, Section 1123
[17] IRC §72(a). Reg. §1.72–1

This includes an annuity death benefit held at interest by the insurance company.[18] It also includes money paid to employees under employer-owned annuities, which is taxed as wages.[19]

B. Other Tax Rules May Also Apply

In addition to the rules in IRC §72, annuities may also be subject to other sections of the Code, tax court cases, revenue rulings and other IRS notices and regulations.

Comment The rules in IRC §72, *not the contract language*, determine the federal income tax treatment on withdrawals. The owner may not, for example, ask the insurance company to report withdrawals only as earnings (or only as a withdrawal of the owner's investment in the contract). The tax result also depends on when the owner bought the annuity, when premiums were paid, the tax status of the payee, and whether the annuity is qualified or non-qualified.

Resource There are other situations when ownership and beneficiary designations may create special tax situations.[20] The Genworth Financial Advanced Marketing team can help you find answers. Email us at advanced.marketing@genworth.com. Clients still need to obtain professional tax advice.

C. Annuity Income is Ordinary Income

Taxable income from an annuity is ordinary income and not capital gain income – even if all taxable income in a variable annuity is from capital gains in an underlying investment subaccount.[21]

D. Rules Vary Based on Type of Distributions

Distributions from an annuity are taxed either as annuity payments (amounts received as an annuity) or as non-annuity payments (amounts not received as an annuity). The tax treatment for each type is fundamentally different. Withdrawals/surrenders have the effect of reducing the contract value and any death benefits. Withdrawals/surrenders of taxable amounts are subject to ordinary income tax and, if taken before age 59½, a 10% penalty tax may also apply. In addition, surrender charges may apply.

V. Income Taxation During the Accumulation Phase

A. Taxation of Earnings Generally Deferred

If a contract satisfies the definition of an annuity and the owner is an individual, the annuity value accumulates income tax deferred until the owner takes a distribution from it, or annuitizes

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[18] Reg. §1.72–14(a). This is taxed as ordinary interest. IRC §61

[19] Reg. §§1.61-2(d), 1.72–14(d), 1.83-1. Consider an employer who buys an annuity to create a reserve for its obligations under a deferred compensation arrangement. An employee is not taxed on premiums paid by the employer on any part of the value of the annuity, if the employer applies for, owns, is beneficiary of, and pays for the annuity. *Casale v. Comm'r,* 247 F. 2d 440 (CA2 1957). The IRS has said it will follow this decision, Rev. Rul. 59–184, 1959–1 C.B. 65; Rev. Rul. 72–25, 1972–1 C.B. 127; Rev. Rul. 68–99, 1968–1 C.B. 193; Priv. Ltr. Rul. 8607032, 8607031 and 8828004. *See also* Priv. Ltr. Rul. 9122019. *See also, Goldsmith v. U.S.,* 586 F. 2d 810, 78–2 USTC ¶9804 (Ct. Cl. 1978). When the employer makes withdrawals and pays the employee, those payments (in the hands of the employee) are ordinary wages, not distributions from the annuity.

[20] For example, annuities held by a tax-exempt entity or pension trust are generally tax-free. Annuities held by certain foreigners may escape U.S. taxation under a tax treaty between the United States and the country of residence, although they may be taxable under foreign law. Income received under annuities held by a trust may be taxable to the trust beneficiaries (if distributed to them), to the person who created the trust (in the case of a "grantor trust"), or to the trust itself (if retained).

[21] IRC §72(b)(2)

or surrenders the contract. To qualify for this deferral, an annuity must comply with specific rules and must not be owned by a non-natural person.[22]

1. Special Rules If the Owner Is Not an Individual

Tax law refers to individuals as "natural persons." Annuities that are not owned by an individual (i.e. are owned by "non-natural persons" such as corporations, trusts, partnerships, etc.) are taxed differently than annuities owned by individuals. The owner of those annuities must pay tax on the annual increase in annuity value – even if those earnings remain in the annuity.[23] Congress' principal reason for allowing tax deferral of gain in the annuity is to promote individual retirement savings. Annuities owned by businesses and other entities do not fulfill that purpose.[24]

Comment The distinction between natural and non-natural owners is important in determining if earnings are taxable. It may also apply to other aspects of annuity taxation and distribution. For example, a non-natural owner may normally not exercise a payout option at death, such as annuitization or stretch, which extends distribution of proceeds over the beneficiary's life expectancy. For a non-natural owner, payout options are generally limited to taking either as a lump-sum or spreading receipt over a period not exceeding five-years from the owner's death'. See Section VII.D.1.c on page 30.

a. General Exceptions

Some owners, even if not individuals, may still enjoy tax-deferred growth in their annuities.

Examples include annuities that are:

- Acquired by an estate because the decedent was the owner,[25]
- Owned by a qualified or employer sponsored retirement plan,[26]
- Part of structured settlements,[27]
- Bought by an employer when a qualified or employer sponsored retirement plan terminates,[28] and
- Immediate annuities.[29]

b. Natural Person Exception

If an owner is *not* an individual but owns the annuity as an agent for an individual, federal tax law nevertheless treats the non-natural owner as an individual.[30] This means

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[22] If the contract does not meet the definition of an annuity per IRC §72, it is treated as an agreement to pay interest. IRC §72 does not allow tax-free payments from those agreements. *See* Reg. §1.72–2(b)(1)(ii); *see also* Rev. Rul. 75–255, *supra.*
[23] IRC §72(u)(1)(B)
[24] Congress believed prior law gave companies the opportunity to fund large amounts of deferred compensation for selected employees on a discriminatory basis. This situation created a disincentive to provide employees qualified plans (which must follow ERISA guidelines). H.R. Rep. No. 426, 99th Cong., 1st Sess. 703 (1985); 1986–3 (Vol. 3) C.B. 703.
[25] IRC §72(u)(3)(A)
[26] IRC §72(u)(3)(B). Plans described in IRC §§401(a) or 403(a), under a program described in IRC §403(b), or under an individual retirement plan. While annuities held by other tax-exempt entities may technically fall under IRC §72(u), the inside buildup in the annuities would ordinarily be tax-free, making lack of tax deferral meaningless.
[27] IRC §130(d)
[28] IRC §72(u)(3)(D). This applies to plans described in IRC §§401(a) or 403(a) and held by the employer until all annuity values are distributed to the employee for whom the annuity was bought.
[29] IRC §72(u)(3)(E)
[30] IRC §72(u)(1)

it does not have to pay income tax on the increase in the annuity value each year. If a non-natural owner is only the *nominal* owner of the annuity, the annual increase in earnings is still not taxable if the *beneficial* owner is an individual.

Example 7. Annuity owned by a corporation.

The Beczkowski Corporation buys an annuity in 2004 and pays a $100,000 premium. On January 1, 2005, the annuity value is $105,000. A year later, the annuity value is $111,000. Because the corporation is a non-natural owner, its 2005 taxable income includes the annuity earnings in 2005 of $6,000 ($111,000 minus $105,000).

Example 8. Distribution by Trust Before Start Date.

A trust owns an annuity that it will distribute to the trust's beneficiary (who is a real person) before the annuity is annuitized. The non-natural person rule does not apply.[31] In other words, the trust is an agent for an individual. Therefore, the trust is an exception to the non-natural person rule that would normally make the annual increase in annuity value taxable to the non-natural person.

Example 9. Trust Making Distributions After Period Certain.

Heather, as trustee of an irrevocable trust buys three single premium deferred annuities. The trust is owner and beneficiary of the annuities. Heather names one of the three trust beneficiaries (all individuals) as the annuitant of each annuity. The trust document states that Heather must terminate the trust and distribute an annuity to each trust beneficiary after a certain period. The non-natural person rule does not apply.[32]

Example 10. Sole Beneficiary of Trust.

Raymond is the sole beneficiary of a trust. The trust buys a single premium deferred annuity. Raymond is the sole annuitant. The non-natural person rule does not apply .[33]

Example 11. Trustee's Powers Limited.

Tomek is a trustee. His duties are limited to buying an annuity as directed by Gladys and to holding legal title to the annuity for Gladys' sole benefit. Tomek may not exercise any rights as owner unless Gladys tells him to do so. The IRS says that Tomek is acting as an agent for a natural person.[34]

Example 12. Irrevocable Trust.

Jason is trustee of an irrevocable trust. In that capacity, he buys an annuity and has the power to select an annuity settlement option or terminate the annuity. Jason is not a beneficiary, but all the beneficiaries of the trust are natural persons. The non-natural person rule does not apply.[35]

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[31] Priv. Ltr. Rul. 9204014 & 9204010
[32] Priv. Ltr. Rul. 199905015
[33] Priv. Ltr. Rul. 9752035
[34] Priv. Ltr. Rul. 9639057
[35] Priv. Ltr. Rul. 199933033 *See* Priv. Ltr. Ruls. 200449011 and 200449013-17. In these rulings, the grantor established non-grantor trusts for the benefit of his grandchildren. Grantor gifted cash to each trust, which purchased annuity contracts with the trust as the owner and beneficiary of each contract. Under the terms of the trusts, the beneficiaries were entitled to withdraw specified percentages of the trust principal upon the attainment of a certain ages (30, 35 and 40). See also, Priv. Ltr. Rul. 200626034.

The distinction between natural and non-natural persons is not always clear. The chart below may help.

Non-Natural Person Ownership			
Owner	*An Exception*	*No Authority*	*Not an Exception*
Legal guardianships	✓		
Custodians (UTMA, UGMA)	✓		
C corporation			✓
S corporation			✓
LLC taxed as corporation			✓
LLC taxed as partnership			✓
Limited Liability Partnership (LLP)			✓
General partnerships			✓
Limited partnerships			✓
Family Limited Partnership (FLP)		✓	Probably
Rabbi Trust			✓
Employer-owned secular trust	✓[36]		
Grantor trust with only individual beneficiaries	✓[37]		
Revocable trust (grantor trust) other than rabbi trust	✓		
Trust holding a group annuity for non-qualified retirement plan funded with after tax contributions	✓[38]		
Grantor ILIT	✓		
Charitable remainder trust			✓[39]
Non-grantor irrevocable trusts (credit shelter trust) when all beneficiaries are individuals	✓[40]		
Funeral trust	✓[41]		
Estate	✓[42]		
Charitable organization			✓[43]

2. Making a Trust the Owner

If the owner's primary concern is avoiding probate, there may be no need for a trust because annuities generally are not subject to probate. However, if there is a concern about providing *management* of the annuity proceeds, a trust may be a viable strategy. There may be, however, disadvantages to naming a trust as the owner of an annuity.

Depending upon the contract language, the trust may have to receive the entire annuity value within five years of the death of the owner or primary annuitant. The trust may not have the option to pay distributions over an individual's life expectancy. In addition, the tax law is not entirely clear in this area.

There is a more detailed discussion of potential problems following death if a trust is the owner or beneficiary beginning in Section VII.D on page 30.

[36] Priv. Ltr. Rul. 9316018
[37] Priv. Ltr. Rul. 199905015, 9752035, 9639057, 9322011, and 9316018
[38] Priv. Ltr. Rul. 200018046
[39] Priv. Ltr. Rul. 9009047. Remember, however, that a CRUT or CRAT is itself tax-exempt. Income is taxable only when distributed by the trust.
[40] Priv. Ltr. Rul. 9204010 & 9204014. All the trust beneficiaries were individuals, including those who have remainder and reversionary interests.
[41] Priv. Ltr. Rul. 9120024. However, the IRS refused to rule on whether, given the facts, the arrangement constituted an annuity.
[42] IRC §72(u)(3)(A)
[43] However, qualified charitable organizations are exempt from federal income taxation.

Hint When using a trust as any party to an annuity, it is good to ask for and to obtain written guidance from the client's tax advisor to make sure that the annuity is structured to accomplish the clients' and advisors' objectives.

B. Multiple Annuities (Aggregation) Rule

1. General Rule

When an owner buys two or more deferred annuities from the same insurance company in the same calendar year, tax law treats all of the annuities as a *single* annuity for purposes of determining the taxable amounts not received as an annuity[44] from *any* of the contracts.[45]

Example 13. Multiple Annuities

Cindy bought a $100,000 deferred annuity (Annuity 1). Later that same year, she bought another deferred annuity (Annuity 2) from the same insurance company. A couple of years later, each annuity had grown by $10,000 (the annuity value of both annuities combined had increased by $20,000). If Cindy takes $15,000 out of Annuity 1, the entire $15,000 will be taxed as gain – even though Annuity 1 by itself has only $10,000 of gain.

Planning Idea To avoid this problem, Cindy may want to spread her purchase of two deferred annuities over two tax years. She could buy one in December of one year and the second in January of the next year. If this is not feasible, she should consider buying the annuities from different insurance companies to avoid the aggregation rules.

2. Exceptions

There are exceptions to the aggregation rule.

- Annuitized contracts.
- Immediate annuities.[46]
- Distributions required on death of the owner.
- Annuities issued before October 21, 1988.[47]

C. Income Taxation of Distributions (Amounts Not Received as an Annuity)

Annuity owners can elect to access the contract values through a number of ways, ranging from a complete surrender (lump sum distribution) of the contract to annuitizing the contract over the annuitant's lifetime. However, not all distributions are treated the same under the Internal Revenue Code.

Most distributions during the accumulation phase are treated as "amounts not received as an annuity." These distributions from an annuity do not qualify as annuity payments. They include such distributions as:

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[44] For a discussion of "taxable amounts not received as an annuity" *see,* Subsection V.C below on page 17.

[45] IRC §72(e)(11). This includes affiliated companies. Applies to annuities issued after October 21, 1988. Enacted to stop the marketing of serial annuities designed to get around the LIFO rules. *See* H.R. Conf. Rep. No. 100–1104 (1988). The rule does not apply to distributions from qualified plans, 403(b) plans, or an IRA. IRC §72(e)(11)(A)

[46] IRC §72(b)

[47] If a pre-October 21, 1988 annuity is later exchanged, the new annuity is subject to the aggregation rules. This does not apply to an annuity received in a 1035 exchange as part of a troubled insurance company's rehabilitation process. Those annuities are treated as entered into on the date the new annuity is issued. The new annuity is not "grandfathered" back to the issue date of the original annuity. Rev. Rul. 92–43, 1992–1 C.B. 288. Priv. Ltr. Rul. 9442030

- Cash withdrawals,
- A partial or complete surrender of the annuity,
- Policy dividends,
- Death benefits,
- Guaranteed lump sum refunds from a refund life annuity settlement,[48]
- Distributions of interest only,
- Loans in which the annuity is collateral for the loan,[49] and
- Any other distributions that are not part of the systematic liquidation of a principal sum.[50]

1. Surrenders of Annuities

a. Complete Surrender

The owner pays tax (as ordinary income), to the extent of earnings in the annuity, on amounts he receives on an annuity's complete surrender, redemption, or maturity, or in full discharge of the obligation under the annuity.[51] Upon complete surrender of an annuity, surrender charges may reduce the taxable amount that might otherwise be recognized.[52] Partial surrenders are not afforded this treatment, as discussed below.

This rule also generally applies to annuities the owner gifts to a non-spouse (for example by changing the owner) and to annuities that are fully pledged as collateral for a loan.[53]

b. Withdrawals and Partial Surrenders

These distributions are taxed either on a "first-in, first-out" (FIFO) basis or a "last-in, first-out" (LIFO) basis depending on when the annuity was issued and when premiums were paid.

(1) Pre-TEFRA Annuities Taxed FIFO

Tax law treats withdrawals from annuities bought before August 14, 1982, first as a recovery of the owner's investment in the contract. Once the owner has recovered her entire investment, all other withdrawals are taxed as ordinary income. Distributions attributable to the owner's investment in the contract reduce basis.[54]

Example 14. Pre-TEFRA Annuity

Anita bought an annuity in 1980 with a single $100,000 premium. After age 59½, when the annuity surrender value is $310,000, Anita makes a partial withdrawal of $140,000. The gain on her annuity is $210,000 ($310,000 minus $100,000). Of the $140,000 she receives, $100,000 is a tax-free recovery of her investment in the contract and $40,000 is taxable. Her basis after the withdrawal is zero.

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[48] Reg. §1.72–11
[49] IRC §72(e)(4)(A)(ii)
[50] Rev. Rul. 75–255, 1975–2 C.B. 22
[51] IRC §72(e)(5)(E). The gain is ordinary income, not capital gain. *See Blum v. Higgins*, 150 F. 2d 471 (CA2 1945).
[52] IRC §72(e)(5)(E)
[53] IRC §72(e)(4)(A)(ii)
[54] IRC §72(e)(3)(B)

(2) Post-TEFRA Annuities Taxed LIFO

Tax law treats withdrawals from annuities bought after August 13, 1982, as from earnings first. Only after the owner has received all earnings are withdrawals treated as a return of the owner's investment in the contract.[55]

Example 15. Withdrawals from a Variable Annuity

Bentley, age 60, buys a variable annuity in 1990. His initial investment is $100,000. Three years later, when the annuity value is $120,000, Bentley withdraws $19,000. Because the annuity value ($120,000) exceeds the investment ($100,000) by $20,000, he pays tax on the entire $19,000. *Note:* If there had been no gain (i.e. there have been no earnings), the amount Bentley would have received would have been tax-free.

(3) Annuities with both Pre-TEFRA and Post-TEFRA Investments

An annuity may have taxable income from both pre-August 14, 1982 and post-August 13, 1982 investments.

Distributions from these annuities are allocated in the following order:

- Tax-free distributions allocated to pre-august 14, 1982 investments, then
- Taxable income allocated to pre-august 14, 1982 earnings, then
- Taxable income allocated to post-august 13, 1982 earnings, and finally
- Tax-free distributions from post-august 13, 1982 investments.[56]

c. The Impact of Surrender Charges on Partial Withdrawals

Unlike a full surrender, when a partial surrender or partial withdrawal is taken, the taxable amount is not reduced by any surrender charges the owner is required to pay.[57]

Example 16. Tax Effect of Surrender Charges.

Amoreli bought a deferred annuity four years ago for $100,000. It currently has an annuity value of $125,000. The annuity has a 6% surrender charge on any withdrawals before the fifth policy year. Amoreli needs $20,000 and decides to take it from her annuity. If the surrender charge is taken from remaining cash value (i.e. a "net check" is processed), she receives the needed full $20,000 but the total distribution will be $21,276.60. That is, in order to net $20,000 she must withdraw $21,276.60 to allow for the payment of the surrender charge. 6% of $21,276.60 is $1,276.60. Amoreli will include the entire $21,276.60 in income.

2. Loans Treated as Distributions

Federal tax law treats loans from a deferred annuity as taxable distributions to the extent of taxable gain in the annuity.[58] A loan for these purposes can be either of two types.

- The owner may actually borrow money from the annuity (if the contract permits loans).

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[55] IRC §72(e)
[56] *See* Rev. Rul. 85–159, 1985–2 C.B. 29
[57] IRC §72(e)(3)(A)(i)
[58] IRC §72(e)(2)(B)

- The owner may pledge the annuity as security for a loan.[59] Tax law treats any part of an annuity pledged as security for a third-party debt as a distribution to the owner, even though the insurance company pays no money to the owner.

The owner increases his basis by the amount included in gross income. Basis is not reduced by non-taxable distributions.[60] In addition, these distributions may trigger the 10% penalty tax if the owner is under age 59½ and does not qualify under another exception.[61]

Example 17. Using Annuity as Collateral

Elnetta buys a variable annuity. Her initial investment is $100,000. Three years later the annuity value is $120,000. Elnetta borrows $19,000 from a bank and pledges the annuity as collateral for the loan. She must include $19,000 of taxable income if (as with a loan from the insurance company) the pledge is limited to the loan amount. She must include $20,000 (the entire gain on the contract) if she pledges the entire annuity value to the bank. In most cases, the bank's paperwork does not specify if the owner pledges only part of the annuity. In that case, the insurance company must assume that the entire annuity has been pledged, resulting in a deemed distribution of the entire annuity value.

D. Losses on Annuities Surrendered or Sold

1. Calculating a Loss

If an annuity owner surrenders or sells an annuity at a loss, the owner may be able to take an ordinary income deduction for that loss. The availability of a deduction appears to depend upon the purpose behind the purchase of the annuity – that is, was the annuity purchased as an investment or to provide for the personal welfare of another person? The ordinary loss seems only to be available if the annuity was purchased for investment purposes.[62] If an owner bought an annuity for personal reasons, not for profit, he may not deduct a loss.[63] You calculate the loss by subtracting the cash value from the owner's basis. The loss is an ordinary loss that can only be taken against ordinary income.[64]

Note There is no loss deduction unless the annuity is sold or completely surrendered. No loss can be recognized from a normal withdrawal, a partial surrender, or an exchange that qualifies under IRC §1035.

Example 18. Loss on SPIA Surrender

Laura bought a single premium refund annuity for $25,000. After receiving payments of $15,000 ($7,000 of which was a return of her investment in the contract), she surrenders the annuity for $10,000. The $7,000 she did not pay tax on reduced her basis from $25,000 to $18,000. The difference between the $10,000 surrender value and basis is taxable income. ($10,000 minus $18,000 = -$8,000). Because it is a negative number, it is a loss.[65]

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[59] IRC §72(e)(4)(A)(ii)
[60] IRC §72(e)(4)
[61] IRC §72(e)(4). Applies to annuities issued after August 13, 1982.
[62] *See George M. Cohan*, 11 BTA 743, *aff'd* 39 F. 2d 540 (CA2 1930). Rev. Rul. 61–201, 1961–2 C.B. 46.
[63] *Early v. Atkinson*, 175 F. 2d 118 (CA4 1949)
[64] I.T. 3567, 1942–2 C.B. 105
[65] Rev. Rul. 61–201, *supra*

Example 19. Loss from Surrender

Kim bought a variable annuity for $100,000. She makes no withdrawals. She decides to surrender the annuity when it is worth $80,000. She pays a $5,000 surrender charge and receives a check for $75,000. Her loss for income tax purposes is $25,000 ($100,000 minus $75,000). Even if she is under age 59½, she will not have to pay the 10% penalty tax because there is no taxable income.[66]

Example 20. Loss on Annuity for Personal Benefit

Joann bought annuities for some relatives for their financial security. Later she ran into financial trouble and her relatives returned the annuities to her. She surrendered them at a loss. She may *not* deduct the loss because she did not originally buy them as an investment. Rather, she bought them to provide security for her family.

2. Reporting a Loss

The IRS has not provided clear guidance on reporting a loss on the surrender of an annuity. There appear to be at least two possible ways to report the loss.

a. Miscellaneous Deduction

The more conservative view is that the owner must itemize deductions. The loss is deductible only to the extent that it exceeds 2% of adjusted gross income.[67] A miscellaneous itemized deduction is subject to the phase-out of itemized deductions for individual taxpayers with income above certain levels.[68] If the owner is subject to the alternative minimum tax (AMT), miscellaneous itemized deductions are not allowed when computing the AMT.

b. Other Gains/Losses

A more aggressive view is that the surrender is equivalent to a sale or exchange of property. Therefore, the loss is deductible under IRC §62(a)(3) and reported on Form 1040 under "Other Gains/Losses." The full loss is deductible without regard to the 2% limit.

E. Withholding on Non-Resident Aliens

If the owner is a non-resident alien, the insurance company must withhold 30% of the taxable portion of any distribution. However, if there is a tax treaty between the United States and the owner's country specifying a smaller withholding amount, the owner may claim the treaty benefits by submitting IRS form W8-BEN and the owner's taxpayer identification number to the insurance company. If a non-resident alien *does not* file the W8-BEN, the insurance company withholds 30% of the portion of any distribution subject to withholding. Distributions to non-resident aliens and foreign corporations are reported on Form 1042-S.

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[66] The 10% penalty tax is paid only on the taxable gain. IRC §72(q)(1). Here there is only a loss, no gain.
[67] Some say the deduction is not subject to the 2% floor.
[68] IRC §68

VI. Income Taxation During the Income Phase

A. Amounts Received As an Annuity

Distributions after annuitization, or “amounts received as an annuity” include traditional annuity options that liquidate the accumulation value over the life expectancy of the annuitant as well as systematic distributions under a fixed period or fixed amount settlement option.[69]

1. Taxation of Annuitized Payments

a. General Rule

Part of each payment is a return of the owner’s investment and is not taxed. The balance is taxed as interest earned on the investment.

The owner receives his or her investment in the contract in equal tax-free amounts during the payment period. This amount is calculated using the exclusion ratio or excludable amount described on page 23. Any additional amount distributed is taxed as ordinary income.

To be entitled to this treatment, an annuity payment must meet *each* of the following three conditions:

- Payments must be received on or after the annuity’s starting date;[70]
- Payments must be made in periodic installments at regular intervals over a period of more than one full year from the annuity start date;[71] and
- It must be possible to determine the total amount of future annuity payments as of the annuity starting date[72] or, in the case of variable annuities, payments will vary only with subaccount investment performance.[73]

b. Expected Return

Expected return is the total amount the owner expects to receive from the annuity payments. It is generally based on the guaranteed (fixed) amount of each annuity payment (even for variable immediate annuities where the payment amount varies depending on investment performance) multiplied by the number of months the owner will receive annuity payments. The owner computes the expected return from a life annuity using IRS actuarial tables.[74]

IRS regulations include specific instructions about how to calculate the expected return for a variety of situations.[75] Owners may need to make adjustments if payments are not

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[69] Reg. §§1.72–1(b) and 1.72–2(b)
[70] Reg. §1.72–2(b)(2)(i). *See,* e.g., Priv. Ltr. Rul. 200305018
[71] Reg. §1.72–2(b)(2)(ii)
[72] Reg. §1.72–2(b)(2)(iii)
[73] Reg. §1.72–2(b)(3)
[74] See tables at Reg. §1.72–9. The tables are to be used in connection with computations under section 72 and the regulations thereunder. Tables I, II, IIA, III, and IV are to be used if the investment in the contract does not include a post-June 1986 investment in the contract (as defined in Section 1.72-6(d)(3)) . Tables V, VI, VIA, VII, and VIII are to be used if the investment in the contract includes a post-June 1986 investment in the contract (as defined in Section 1.72-6(d)(3)) . In the case of a contract under which amounts are received as an annuity after June 30, 1986, a taxpayer receiving such amounts may elect to treat the entire investment in the contract as post-June 1986 investment in the contract and thus apply Tables V through VIII.
[75] Payment of a fixed monthly amount for the life of one annuitant. Reg. §1.72–5(a)(1). *See* Reg. §1.72–5(a)(2) (providing adjustments necessary if payments are made quarterly or less than quarterly). Fixed payments to be made until the death of the annuitant or until the expiration of a specified limited period, whichever occurs earlier. Reg. §1.72–5(a)(3). Lifetime annuity payments, but the payments are to be reduced after a certain period. Reg. §1.72–5(a)(4). Lifetime annuity payments, but the payments are to increase after a certain period. Reg. §1.72–5(a)(5). Joint and survivor annuity providing an identical monthly income for the life of the first annuitant and, after his death, the life of the second annuitant. Reg. §1.72–5(b)(1). *See* Reg.

monthly. A further adjustment may be needed if the interval between the annuity's maturity date and the date of the first annuity payment is less than the interval between future payments.[76]

For a period certain only annuity, the expected return is computed by multiplying the annuity payment by the number of annuity payments the owner will receive.[77] For a life annuity with a certain period, it is calculated by adjusting the expected return from the life portion of the annuity for the present value of the refund feature (the guaranteed payments).

For variable annuities, the expected return is unknown, but federal tax law treats it as being the same as the annuity's basis.[78] The excludable portion of each variable payment is calculated by dividing basis by the number of years the owner will receive annuity payments.[79] All amounts the owner receives in excess of the excludable amount are taxable. The owner may elect to adjust the excludable amount in the following year if, because of poor investment performance, the annuity payments are less than the excludable amount.

c. Exclusion Ratio or Excludable Amount

When an owner annuitizes an annuity contract, the annuity value is changed into an income stream. Part of each annuity payment is taxable and part is not. The insurance company calculates the exclusion ratio to determine which part of the payment is not taxable (the excludable amount) and which part is taxable (the taxable amount). To determine the exclusion ratio, the insurance company divides the owner's investment in the contract by the number of payments it will pay during the annuity period.[80] Each annuity payment is multiplied by the exclusion ratio to determine what part of each payment is a return of the owner's investment in the contract (the excludable amount, which is *not* taxed) and what part is from earnings on the contract (the taxable amount, which *is* taxed).

The number of payments expected varies depending on the type of payout option selected and the frequency of payments.

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§1.72–5(a)(2) (providing adjustments necessary if payments are made quarterly or less than quarterly). Joint and survivor annuity providing a fixed monthly income for the life of the first annuitant and, after his death, a different amount for the life of the second annuitant. Reg. §1.72–5(b)(2). Joint and survivor annuity where the first annuitant died in 1951, 1952, or 1953. The survivor's basis in the annuity was determinable under §113(a)(5) of the Internal Revenue Code of 1939. Reg. §1.72–5(b)(3). Two annuitants, and provides for fixed monthly payments to be made as a joint life annuity until the death of the first annuitant to die. Reg. §1.72–5(b)(4). Joint and survivor annuity providing for certain payments while both annuitants are alive and a different amount to be paid to the survivor. Reg. §1.72–5(b)(5). Payment of life annuities to two persons for their lives, and after the death of one, the other is to receive both annuities for the remainder of his life. Reg. §1.72–5(b)(6). Joint and survivor annuity under which variable payments are to be made. Reg. §1.72–5(b)(7) and the examples thereunder. Two or more annuity elements were acquired for a single consideration. Reg. §1.72–5(e). Variable payments (either in whole or in part). Reg. §1.72–5(f). The annuity premiums were paid both before July 1, 1986 and after June 30, 1986. Reg. §1.72–5(g)

[76] Reg. §1.72–5(a)(2). Adjustments must also be made if you have certain periods or joint and survivor annuities.

[77] IRC §72(c)(3). *See* Reg. §§1.72–5(c) and (d)

[78] Reg. §1.72–4(d)(3)(i)

[79] Reg. §1.72–4(d)(3)(i). Calculate the number of anticipated payments by multiplying the total number of payments to be received each year by either (a) the number of years payments are to be made or (b) by the appropriate multiple in Reg. §1.72–9 (as adjusted in accordance with the table in Reg. §1.72–5(a)(2) where the payments are to be made for a life or lives). *See* Reg. §1.72–2(b)(3)(ii). The taxpayer must file a statement with his or her tax return giving the information outlined in Reg. §1.72–4(d)(3)(iv).

[80] If the basis equals or exceeds the expected return, the full amount of each payment is received tax-free. Reg. §1.72-4(d)(2). Reg. §1.72–4(a)(2) requires rounding to the nearest tenth of a percent.

For annuities issued on or after January 1, 1987, the owner uses the exclusion ratio only until she has "recovered" or been repaid her entire investment in the contract. For a life expectancy annuity, this is when she reaches her actuarial life expectancy. Thereafter, all annuity payments are taxable as ordinary income.[81]

Although the exclusion ratio may change in some circumstances,[82] it generally continues to apply until:

- The annuity is assigned or transferred for valuable consideration,[83]
- The annuity is surrendered, redeemed, or discharged,[84] or
- The annuity is exchanged.[85]

2. Rules for Specific Types of Annuities

a. Fixed Annuities

An owner does not pay income tax on distributions representing a return of investment in the contract. The amount not taxed is equal to the annuity payment times the exclusion ratio.

Example 21. Exclusion Ratio of Fixed Annuity

Kathi-Lyn paid $12,650 for an annuity making annuity payments of $100 per month. The expected return is $16,000. The exclusion ratio is $12,650/$16,000 or 79.1%. She receives 12 annuity payments in 2004. She does not have to pay tax on $949.20 ($1,200 times 79.1%). She includes as taxable income the balance of $250.80 ($1,200 minus $949.20). If instead she received only five annuity payments during the year, she would exclude $395.50 ($500 times 79.1%) and pay tax on the rest.[86]

Example 22. Exclusion Ratio after Life Expectancy

Using the same facts as in example 21, after Kathi-Lyn receives 159 payments, she will have recovered $12,576.90 of her investment. When she receives her next payment, she may exclude only $73.10 ($12,650 minus $12,576.90) from gross income. She pays tax on the other $26.90. Thereafter, she includes the entire payment as ordinary income.

b. Variable Annuities

Because annuity payments from a variable annuity may vary with subaccount investment performance, special rules let the owner recover his investment in the contract ratably during the payout period. The exclusion ratio is still calculated by dividing basis by the number of payments expected during the annuity period.

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[81] IRC §72(b)(2) and 72(a). This rule does not apply to annuities bought to settle life insurance death benefits. The exclusion ratio for these supplemental annuities is determined under IRC §101(d), not IRC §72(b), and applies to all payments received. For joint and survivor annuities with a start date after Dec. 31, 1986, the exclusion ratio originally determined may be used to exclude amounts from income, but the total exclusion (by the first annuitant and the survivor) may not exceed the basis.
[82] Partial lump sum withdrawal causing a reduced annuity for the same payments for a different term. Reg. §1.72–11(f). Payments from a variable annuity fall below the excluded amount. Reg. §1.72–4(d)(3). If the annuity is bought after payments begin under a life income or installment option, a new exclusion ratio must be determined, based on the buyer's cost and expected return computed as of the buyer's start date. Reg. §§1.72–4(b)(2) and 1.72–10(a)
[83] Reg. §1.72–4(a)(4)
[84] Reg. §1.72–11(c) or (d)
[85] *See* Reg. §1.72–11(e) regarding deemed exchanges.
[86] Reg. §1.72–4(a)(2)

Example 23. Excludable Amount of Variable Annuity

Matthew paid $100,000 for a variable annuity. He annuitizes the contract on June 30, 2000, the annuity start date. On that date he is 64 years old and has a life expectancy of 20.8 years. He receives a $7,000 payment on June 30, 2001. The excludable amount is $4,926.11, determined by dividing the basis in the contract ($100,000) by Matthew's life expectancy (adjusted for annual payments) as of the original start date (20.8 minus 0.5 = 20.3). The taxable portion of his $7,000 payment is equal to $2,073.89. The excludable amount remains $4,926.11 for 20.3 years. After 20.3 years (assuming that all of his annual payments have equaled or exceeded $4,926.11, the excludable amount), subsequent payments from the variable annuity will be fully taxable as ordinary income., assuming no annual payments received previously were below the excludable amount for the year received.

Example 24. Excludable Amount of Variable Annuity

Matthew paid $100,000 for a variable annuity. He annuitizes the contract on June 30, 2000, the annuity start date. On that date he is 64 years old and has a life expectancy of 20.8 years. He receives a $4,000 payment on June 30, 2001. The excludable amount is $4,926.11, determined by dividing the basis in the contract ($100,000) by Matthew's life expectancy (adjusted for annual payments) as of the original start date (20.8 minus 0.5 = 20.3). He pays no tax on the $4,000 payment in 2001 because it is less than the actual excludable amount.

He receives no other payment until June 30, 2003. Matthew may elect, on his 2003 federal tax return, to recalculate the excludable amount as of June 30, 2002. To determine what part of his 2003 payments he may treat as a recovery of his investment in the contract, Matthew does the following calculations.

1. Determine the total amount excludable in 2001 and 2002.
   (2 times $4,926.11 = $9,852.22).
2. Subtract the amount he actually received.
   ($9,852.22 minus $4,000 = $5,852.22).
3. Determine his adjusted life expectancy (because payments are made annually) and divide the result in line 2 by that number. Use the owner's age at his nearest birthday (66) on the first day of the first period for which he received an amount as an annuity in the taxable year of election (June 30, 2002). (19.2 minus 0.5 = 18.7). Therefore, line 2 divided by line 3 is ($5,822.22 divided by 18.7 = $312.95).
4. Add the result from line 3 to the earlier excluded amount.
   ($312.95 plus $4926.11 = $5,239.05)
   This is the amount excludable in 2002 and each year thereafter.

In this example, Matthew received amounts less than the excludable amounts in two successive years and deferred making his election until the third year. This let him accumulate the part of the payments for two years that were a recovery of his investment in the contract.[87]

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[87] Reg. §1.72–4(d)(3)(iii)

3. Annuity in Lieu of Lump Sum Option

There may be situations when the insurance company must distribute the annuity value and the owner or beneficiary does not want to receive it in a single payment because of the income tax consequences.[88] The beneficiary, for example, may have the option to receive the annuity value as annuity payments over the beneficiary's life expectancy or as an installment option. See the discussion in Section VII.C.3 on page 28. The exclusion ratio, in this situation, is computed using the decedent's basis and the beneficiary's expected return.

VII. Income Taxation of Distributions Following Death

A. Death of an Owner Forces a Distribution if the Beneficiary is not a Surviving Spouse

To entitle the owner to defer paying income tax on gain in the contract, an annuity contract must require that the insurance company begin distributions when the owner dies if the beneficiary is not the Surviving Spouse.[89] If a trust or anyone other than an individual owns the annuity, the insurance company must begin distributions when the primary annuitant dies[90] or when the primary annuitant is changed.[91] This rule prevents a succession of beneficiaries from perpetually deferring taxes simply by not taking withdrawals.

If there is more than one owner, the death of any owner triggers this requirement.[92] In an annuitant-driven annuity, the death of any annuitant may also trigger the distribution requirement, as governed by the contract provisions. Make sure that you examine the contract language to confirm what happens to the contract at the death of an owner or annuitant.

1. Distribution Options If Death Is *Before* the Annuity's Maturity Date

In addition to limitations imposed by an insurance company in its annuity contract, Congress and the IRS have created limits that affect the timing of distributions triggered by a death. These rules exist to prevent the perpetual deferral of income taxation through successive ownership.[93]

The insurance company must begin making distributions of the entire interest in the annuity within five years after the owner's death. The distribution must be made according to one of the following five methods.[94]

- Lump sum paid immediately.
- Complete withdrawal within five years.[95]

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[88] IRC §72(h). The lump sum payment must be a full discharge of an obligation under the annuity, subject to an option to receive an annuity in lieu of a lump sum. The annuity option must be exercised within 60 days after the day when lump sums first became payable. Finally, part or all of the lump sum would (but for the application of this "in lieu of lump sum" rule) be includible in gross income. These rules apply for annuities where the start date is after July 1, 1986.

[89] IRC §72(s). This applies to annuities issued after January 18, 1985.

[90] IRC §72(s)(6). IRC §72(s)(6)(B) defines primary annuitant as an individual. This applies to annuities issued after April 22, 1987.

[91] IRC §72(s)(7)

[92] TRA '86, Sec. 1826. This applies only to annuities issued after April 27, 1987.

[93] *See* DEFRA Bluebook, *supra*, at 659. This was enacted for annuities issued after January 18, 1985 to prevent generational tax skipping. It later became applicable to "any holder" after April 22, 1987.

[94] IRC §72(s). If a contract fails to comply with IRC §72(s), it is not an annuity for federal income tax purposes (and therefore not entitled to preferential tax treatment). These are not the same as the annuitization options during life.

[95] IRC §72(s)(1)(B). A subtle difference exists between the five-year rule for qualified and non-qualified annuities. Non-qualified annuities using this rule must pay out the entire annuity value within five years of the owner's death. With IRAs and qualified plans, the distribution must be made no later than December 31 of the calendar year that contains the fifth anniversary of the date of the employee's death. It is wrong to assume that a non-qualified distribution may be delayed until the end of the fifth year following the year of death, applying the rule for IRAs and qualified retirement plans.

- Beginning within one year of the holder's death, lifetime annuity payments to a beneficiary, or payments over a period not extending beyond the beneficiary's life expectancy.[96] See Section VII.C.3 on page 28 for a warning.
- Beginning within 350 days[97] of the holder's death, non-annuitized required minimum annual distributions ("stretch payments") based on the life expectancy of the beneficiary.
- Spousal continuation of the annuity. A surviving spouse may have the right to continue the annuity without taking distributions. If the beneficiary is the owner's surviving spouse, the distribution requirements are applied by treating the spouse as the new owner.[98] If the contract owner is a trust, spousal continuation may not be available even if the surviving spouse is the trustee or trust beneficiary.[99]

Genworth Annuities issued by the Genworth Financial companies allow the owner to use the spousal continuation option only once. If the contract is continued, and the surviving spouse (the new owner) remarries and then dies, our contracts do not permit the new spouse to continue. In this respect, the contract is more restrictive than the tax law.

2. Distribution Options If Death Is *After* the Annuity's Maturity Date

If the owner of the annuity dies *after* the contract has been annuitized and before the entire annuity value has been distributed, whatever remains of the annuity value must be distributed at least as rapidly as required by the payout option in effect when the owner died.[100] If a beneficiary receives the remaining payments under the annuity payout option in effect at the owner's death, the taxable and nontaxable portions of the payments will continue to be determined by the original exclusion ratio.

Note If the owner's spouse is the beneficiary, then the spousal continuation rules discussed above may also apply.

B. General Rule for Taxation of Death Proceeds

Any proceeds payable from an annuity because of the owner or annuitant's death are generally taxed on the gain in the contract when distributed.

- The gain, if any, is ordinary income to the beneficiary.
- Gain in the annuity is measured by subtracting (1) total gross premiums from (2) the death benefit plus total dividends and any other amounts received under the annuity that were not taxed when received.[101]

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[96] "Designated Beneficiary" is any individual designated as a beneficiary by the owner. IRC §72(s)(4). Distributions may be made over the life of the beneficiary (or over a period not exceeding the beneficiary's life expectancy). IRC §72(s)(2)(B). In Priv. Ltr. Rul. 200313016, the IRS ruled that the three distribution methods (required minimum distribution, fixed amortization, and fixed annuitization) satisfy the requirements of IRC §72(s)(2).

[97] While the Code requires distributions to begin within 1 year of death, Genworth's requirement is shorter, only 350 days.

[98] IRC §72(s)(3). As long as he or she is a beneficiary, a surviving spouse of a deceased owner has the additional option of becoming the owner, and continuing the annuity throughout his or her life. There is no forced distribution. IRC §72(s)(3) says that "the" designated beneficiary needs to be a spouse to become an owner. Spousal continuation rights in a non-qualified annuity are largely determined by the contract language.

[99] *See*, Priv. Ltr. Rul. 200622020. These cases may turn upon the specific wording of the trust document and the facts of the case. Also, remember that the distribution rules governing qualified plans and IRAs contain rules that allow you in general terms to "look through" a trust, and treat the trust beneficiaries as the beneficiaries of the qualified plan or IRA. This provision is not available for nonqualified annuity contracts.

[100] For IRC §72(s) purposes, if an owner's spouse is the beneficiary, then the rules of IRC §§72(s)(1) and (2) are applied as though the spouse were the owner. IRC §72(s)(3)

[101] IRC §72(e)(5)(E); Reg. §1.72–11(c); Rev. Rul. 55–313, 1955–1 C.B. 219. *See Malesa v. Comm'r,* T.C. Memo 1996–396.

C. Death Benefits

A death benefit paid under the terms of an annuity contract is not the same as the death benefit paid under a life insurance policy and does not qualify for tax exemption *as a life insurance policy death benefit* that is payable because of an insured's death.[102] While it has a mortality component, the insurance company's principal risk is an investment risk. Normal annuity principles apply.

1. Death Benefit Equal to the Annuity or Contract Value

The annuity value at the time of death.

2. Enhanced Death Benefits

Enhanced death benefits are typically offered as riders to an annuity, and they vary significantly.

- A common basic death benefit rider may pay the greater of premium payments contributed or the account value upon the death of the annuitant or owner.
- "Annual step-up" riders generally pay the greater of the basic death benefit or the highest anniversary account valve reached within certain time or age limits.
- "Rollup" riders may pay the greater of the contract's basic death benefit or the total premium payments accumulated at a specified interest rate until a specified balanced is reached.
- Other riders may pay a specified percentage of the gain in the contract to assist beneficiaries in paying taxes on the death benefits.

Contracts differ as to whether the death benefits are paid or credited upon the death of the annuitant or death of the owner. Most death benefit riders are optional and may be purchased for an additional charge.

3. No Immediate Tax if Benefit Annuitized

A beneficiary can delay tax on the death proceeds if he elects annuitization as his payout option. If he makes this election, the periodic payments are taxed under the regular annuity rules. Distributions must begin within one year.[103] The exclusion ratio for the annuity is based on the *decedent's* basis and the beneficiary's expected return. Once the beneficiary exceeds his or her life expectancy, all additional annuity payments are taxed as ordinary income.[104]

Genworth Insurance companies may have their own requirements about when the beneficiary must make this decision. For example, Genworth requires that the beneficiary make the decision within 30 days after we are *notified* of the death.

4. No Immediate Tax if Benefit Stretched

a. Electing Stretch.

The beneficiary has up until 350 days after the owner's death in which to elect the Stretch payout option. Stretch is not available if the beneficiary has already elected to take a lump sum distribution or to annuitize his payout.

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[102] IRC §101(a)
[103] Receipt of payments over life or life expectancy by the beneficiary must begin within 1 year of the owner's death (IRC §72(s)(2)(C)), not by the end of the year following death as with IRAs, etc. IRC §72(s)(2). Distributions are deemed to have been made in their entirety on the day they begin.
[104] Reg. §§1.72–11(a) and (e)

b. First Stretch Payment.

The first stretch payment is based on the contract value as of the earlier of 12/31 of the year of the owner's death, or the date of the first stretch withdrawal. The contract value is then divided by the beneficiary's life expectancy, based on the beneficiary's age in the year of death and as determined by the Single Life Table.[105] The first required minimum withdrawal must be taken within 350 days after the owner's death.

c. Subsequent Payments.

Required minimum withdrawals must be taken annually thereafter, no later than the anniversary of the date of the first stretch withdrawal. Minimum withdrawal amounts are based on the contract value as of 12/31 of the preceding calendar year, divided by the beneficiary's life expectancy taken from the Single Life Table (Unlike beneficiary IRAs, life expectancy is recalculated each year). Payments will continue until the contract value is reduced to $0.

d. Subsequent Beneficiaries.

If the beneficiary dies before the contract value is entirely distributed, the beneficiary's beneficiary may continue to receive required annual distributions over any remaining, unused life expectancy period of the deceased (no annual recalculation of life expectancy).

Genworth No optional living or death benefits are available on a stretched Genworth deferred annuity contract. Upon the beneficiary's death, their beneficiary receives the contract value, with no additional step up.

Planning Idea If the owner is able to distribute the annuity proceeds over a longer period, there are two benefits. First, there is the continued deferral of gain in the annuity. Second, she may avoid taxation in a higher income tax bracket caused when a single large distribution is added to her other income.

Example 25. Stretch Payout

Chester Gooch, age 67, dies on July 15, 2008, leaving his son, Fielder, age 45, as the beneficiary of his $400,000 non-qualified deferred annuity. Fielder elects to take distributions under the stretch payout option beginning February 15, 2009. The account value as of 12/31/08 is $425,000. Fielder receives his first required distribution of $10,954 ($425,000 contract value / 38.8-year life expectancy at age 45) on 02/15/09. Fielder's next required minimum distribution is on 02/15/10. If the contract value as of 12/31/09 is $449,000, his required distribution amount is $11,847 ($449,000 / 37.9). Remember, though, that Fielder can take more than his required distribution amount. If he withdraws a total of $111,847 on 02/15/10. How much of this is subject to surrender charges? Gain in the contract is not subject to surrender charges, so deduct $49,000. This leaves $62,847. Subtract from that the free withdrawal amount ($40,000). A total of $22,847 is therefore subject to surrender charges.

Note Taking more than the required minimum distribution in a given year will reduce the account value for purposes of determining the

[105] Reg. §1.041(a)(9)-9(a)(1)

following year's minimum distribution amount. The additional sum taken, though, cannot be used as a "credit" against the next year's required minimum distribution.

D. Potential Problems If a Trust Is the Owner or Beneficiary

1. General Potential Problems

a. Trust as Owner

When a trust owns an annuity, the trustee must normally name the trust as the annuity beneficiary; otherwise the trustee may violate his or her fiduciary duty to the trust beneficiaries.[106]

b. Possible Loss of Spousal Continuation Rights

Depending upon the terms of the annuity contract, spousal continuation may not be available if a trust is the owner of an annuity. For example, a husband and wife might make a trust the owner of an annuity, the husband the annuitant, and the wife the designated beneficiary with the intention of securing a stepped-up death benefit for the wife upon the death of the husband. However, upon the death of the annuitant husband, some annuities immediately make the contract owner the designated beneficiary of the annuity. Since the contract provisions of such an annuity now make the trust the designated beneficiary rather than the surviving spouse, the surviving spouse's options normally available under the spousal continuation rules would be reduced. The language of the annuity contract should be carefully read to determine the effects of various ownership and annuitant designations.

c. Possible Loss of Lifetime Annuitization

Annuitization over an individual's life expectancy may not be available if a trust is the owner or beneficiary of an annuity. For example, some annuities will make the owner-trust the designated beneficiary upon the death of an annuitant. This designation of the trust as beneficiary may eliminate the option normally available to a surviving annuitant or named beneficiary to receive the remaining value of the annuity over his or her life expectancy. This means that the only distribution option available to a trust that owns such an annuity is a lump sum distribution or payment of the annuity value within five years. The trust would not have the option to stretch distributions over an individual's life expectancy. However, other annuities may make the annuity payments directly to the named beneficiary or contingent beneficiary without reference to the trust. The language of the annuity contract should be carefully read to determine how the rights of parties are affected if a trust owns the annuity.

Caution Unless the trust distributes the proceeds to the trust beneficiaries in the year of receipt, it will pay tax on those distributions at high trust income tax rates, possibly higher than the trust beneficiary would pay.

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[106] If the trustee does not make the trust the annuity beneficiary, the rights of beneficiaries under the terms of the trust may be adversely affected. For example, let's say the trustee makes the grantor's children, A and B, the annuity beneficiaries. Under the terms of the trust, if A or B die, the grandchildren receive per capita shares. Under the terms of the annuity contract, if A or B die, the survivor of the two receives the proceeds. Therefore, if B dies, A receives the proceeds under the annuity contract terms, and the trustee has broken his fiduciary duty to the grandchildren trust beneficiaries. *In part for this reason, many insurance companies contractually make the trustee the designated beneficiary of a trust-owned non-qualified annuity immediately upon the death of any annuitant.*

2. Trust Type Considerations

a. Trusts Designed to Hold Annuities.

Some trusts are specifically designed to purchase and hold annuities. In 1999, two parents decided to use a trust-owned annuity to provide retirement funds for their son with the advantages of tax deferral, guaranteed withdrawal benefits, spendthrift protection, and creditor protection.[107]

b. Unified Credit Trust.

Also known as a “credit shelter trust” or “B” trust, this trust is usually designed to shelter the maximum amount possible from estate taxes when a person dies. Couples whose combined wealth exceeds $2 million most commonly use the “B” trust (the applicable credit amount shelters $2 million per individual in assets from estate tax in 2008). However, this trust may also be used simply to avoid probate.

(1) Before the Grantor Has Died

If the “B” trust is also an “inter vivos” or “living” trust, then the Grantor has probably funded the trust with assets during his lifetime. Living unified credit trusts are generally not the best type of trust to buy annuities because a taxable event may occur at the grantor’s death. (Under grantor trusts, the grantor is considered the owner of trust assets for income tax purposes. Since annuity proceeds must be distributed when a natural owner dies, most insurance companies interpret this to mean that grantor trust-owned annuity proceeds must be distributed when the grantor dies). However, this may not be an important factor in all living unified credit trusts, especially where avoiding probate is the primary reason for the trust.

(2) After the Grantor Has Died

Annuity ownership by a unified credit trust may be more suitable after the grantor has died. If the income beneficiary is the annuitant (usually the surviving spouse), the death of the annuitant will cause the annuity to be distributed. However, if the remainder beneficiaries are the annuitants (usually the children), the annuities may be distributed to them when the income beneficiary (usually the last surviving parent) dies without forcing a distribution of the annuity proceeds. However, caution must be exercised to not impinge on the surviving parent’s income rights.

c. Marital Deduction Trust

This trust is designed to qualify its assets for the unlimited marital estate tax deduction. It usually becomes effective after the first spouse dies.[108] Depending upon the terms of the trust, an annuity may be a suitable investment. However, there are a couple of alternatives to a marital deduction trust:

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[107] Priv. Ltr. Rul. 199933033. Parents created and put money into a trust that purchased a deferred annuity contract with Son as the annuitant. The ruling states, “In order to maximize the potential investment gains from the initial gift, the Grantors desire that the investment gains from the gift benefit from tax deferral (thus they propose to use a deferred annuity) …The Grantors will contribute cash to Trust which will be used by Trust to purchase a deferred annuity from ... a commercial life insurance company. Son will be the annuitant. The annuitization date will be when Son ... reaches age *y*. Trust will continue for Son’s lifetime and will terminate upon Son’s death.”

[108] The surviving spouse/parent has rights to all trust income and normally has significant rights to trust principal.

(1) Remove Assets from the Trust

The surviving spouse/parent may wish to remove assets from the marital trust to buy an annuity. The surviving spouse/parent might be the owner and annuitant with the children as the beneficiaries.[109]

(2) QTIP Trust

This special type of marital deduction trust is often used where a grantor wants to make sure that his or her children from a previous marriage receive the trust property after both the grantor and the current spouse have died.[110] The surviving spouse has a right to all the income during his or her life, but the principal will go to the remainder beneficiaries when the spouse dies. Because the undistributed gains inside of an annuity are not defined as income in most states, annuities may not be appropriate for this type of trust unless the trustee and all beneficiaries agree on specific parameters for any annuity withdrawals.[111]

E. Other Income Tax Issues Following Death

1. Ten Percent Penalty Tax

Distributions paid when the owner dies are not subject to the 10% federal penalty tax on premature distributions. Most insurance companies take the position that this “death of the holder” exception to the 10% penalty tax *does not* apply to distributions made when a non-owner annuitant dies. However, other companies take a minority view that the “death of the holder” exception to the 10% penalty tax *does* apply if the contract language requires distribution to the beneficiary upon the death of an annuitant. See, Section VIII.A.2.b of this outline on page 36.

2. Income in Respect of a Decedent

Death benefits are income in respect of a decedent (IRD) to the extent of taxable income. Those receiving federal IRD payments may be able to deduct from their income tax what the owner’s estate paid in estate taxes attributable to the IRD.[112]

3. Step Up In Basis

At the death of an estate holder, the estate sometimes receives a step-up in basis on certain assets. This means that the basis in the hands of the estate beneficiaries will be the fair market value of the asset as of the date of death, or alternate valuation date, rather than the decedent’s basis in the asset. If the beneficiaries subsequently sell the asset, the reportable gain will be calculated using this increased basis, potentially reducing taxable income.

Variable Annuities issued before October 21, 1979, receive a step up in basis to the contract value of the annuity when the owner dies. This means the beneficiary does not have to pay income tax on the deferred gain. However, if the contract is exchanged under IRC §1035 for a contract issued after October 20, 1979, the benefit of the step up in basis is lost.[113]

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[109] Upon the death of the spouse/parent, the annuity proceeds could be paid as a lump sum, over five years, or “stretched” over the lives of the children beneficiaries. The proceeds would normally not be subject to probate.

[110] QTIP stands for Qualified Terminal Interest Property. The surviving spouse has rights to all the income, but the principal will go to the remaindermen upon the spouse’s death.

[111] The problem cited above has do with the definition of income. In some states, undistributed gains in an annuity contract are not income, and therefore do not have to be distributed to the income beneficiary.

[112] Priv. Ltr. Rul. 200041018

[113] IRC §1014(c). Priv. Ltr. Rul. 9245035. Applies only to annuities issued before October 21, 1979, including any contributions applied to an annuity pursuant to a binding commitment entered into before that date. Death must occur before the annuity’s maturity date. The annuity must not have been exchanged under IRC §1035 after that date. The new basis will be the

Note For variable annuities issued after October 20, 1979, and for all fixed annuities, there is no step-up in basis.

4. Death Before Basis Is Recovered

If an owner is receiving annuity payments from a life only annuity and dies before recovering her entire investment in the contract, her estate may deduct the entire unrecovered basis.[114] It takes this loss deduction on the owner's final federal income tax return.[115] This is an ordinary loss deduction; the estate may carry it back to earlier income tax returns.[116]

Example 26. Owner's Death Before Life Expectancy

Greg buys a deferred annuity with a premium payment of $80,000. He is the owner and annuitant. Five years later, the annuity is worth $120,000. Greg annuitizes the contract. He chooses a straight life annuity. During his life expectancy, part of each payment is tax free as a return of his investment in the contract. If Greg lives beyond his life expectancy, each payment will be taxed as ordinary income. However, Greg does not outlive his life expectancy. At his death, he has received only $50,000 of his $80,000 investment in the contract. When completing Greg's final federal income tax return, his executor may deduct the remaining $30,000 investment in the contract as an ordinary loss.

If instead, the annuity payments continue to a beneficiary after the owner dies, the beneficiary may deduct the amounts representing the unrecovered investment in the contract in the taxable year the beneficiary receives the payments.[117] This is a fancy way of saying that until the beneficiary recovers the rest of the investment in the contract, the annuity payments are tax-free.

However, if the amount due under the annuity is applied to a new annuity, the remaining basis is transferred to that annuity and the owner gets a new exclusion ratio.[118]

Example 27. Early Death with Period Certain

Same as Example 26, except the owner is Blake who buys a deferred annuity with a payment of $80,000. He is the owner and annuitant. When Blake annuitizes, he chooses a 20-year certain and life payout and begins receiving $7,500 per year. Under the exclusion ratio, $3,500 of each payment will be income tax free as a return of basis.

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value of the annuity at the date of the decedent's death (or the alternate valuation date). If that basis equals the amount received by the beneficiary, there will be no taxable gain and the growth in the annuity value while owned by the decedent will escape income tax entirely. Rev. Rul. 79–335, 1979–2 C.B. 292. But where a variable annuity bought before October 21, 1979 had been exchanged for another variable annuity under IRC §1035 after October 20, 1979, and the annuity owner died before the annuity's maturity date, the beneficiary was not entitled to a step-up in basis. Priv. Ltr. Rul. 9346002 and 9245035

[114] For purposes of IRC §72(b), "unrecovered Investment in the Contract" is generally defined as the basis as of the annuity's maturity date minus the aggregate amount received under the annuity on or after the annuity's maturity date (and before the date as of which the determination is being made) to the extent that the amounts were excludible from gross income. IRC §72(b)(4). For this purpose, any adjustments for the presence of a refund feature (i.e., reductions in the basis for payments in the nature of a refund) are to be disregarded. *Supra Cf.* IRC §72(c)(2)

[115] IRC §72(b)(3)(A). These rules apply for annuities where the start date is after July 1, 1986. This ordinary loss deduction may be carried back to the taxpayer's prior tax returns. This deduction is limited to amounts in excess of those amounts not included in gross income by reason of IRC §72(e)(5)

[116] IRC §72(b)(3)(C). For purposes of determining if the individual has a net operating loss, the deduction is treated as if it were attributable to a trade or business. The loss is not subject to the 2% minimum floor applicable to itemized deductions. The loss is counted in the calculation of alternative minimum taxable income.

[117] IRC §72(b)(3)(B)

[118] Reg. §1.72–11(e)

Blake's son, Cole, is his beneficiary. If Blake dies within the 20-year term certain period, Cole will continue to receive annuity payments until the end of that 20-year period.

Blake dies 10 years after receiving his first payment. There is $45,000 in unrecovered basis ($80,000 – [10 x $3,500]). Each year thereafter, and until the end of the 20th year, Cole will receive $7,500. In each of the first six years, Cole may deduct the $7,500 against the unrecovered investment in the contract. He pays no tax on the distributions in those years. After six years and the recovery of all of Blake's investment in the contract, Cole includes the entire $7,500 as ordinary income. This represents a reversal of the LIFO rule.

Example 28. Early Death with Life Annuity

Same as Example 26 except Brett buys a deferred annuity for $80,000, naming Bryant as his beneficiary. Brett dies before the annuity matures. When Brett dies, his annuity is worth $120,000, of which $80,000 is his unrecovered investment in the contract. Bryant uses the death benefit to buy a life annuity for himself. Bryant receives the unrecovered investment in the contract from Brett's original annuity over his life expectancy. In effect, Bryant receives an exclusion ratio based on his life expectancy, but with Brett's basis.

Similarly, a refund beneficiary may deduct any unrecovered investment in the contract in excess of the excludable refund.[119]

Example 29. Early Death with Lump Sum Death Benefit

Same as Example 26, except the owner is Troy who purchases a deferred annuity for $80,000 and names his daughter, Debbie, as beneficiary. When Troy dies, Debbie receives a lump sum death benefit of $100,000. Debbie deducts $80,000, representing the unrecovered basis in the annuity, and includes the other $20,000 as ordinary income.

VIII. Other Income Tax Considerations

A. Premature Distributions Result in Penalty Tax

1. General Rule

To discourage the use of annuities as short-term tax-sheltered investments, Congress created an additional income tax for certain premature distributions.[120] This 10% federal penalty tax applies only to the taxable part of a withdrawal.[121] This penalty tax is in addition to the ordinary income tax that must be paid on any recognized gain on the distribution.

Example 30. Owner Under Age 59½

John, age 49, owns a deferred annuity. His investment in the contract is $100,000 and it now has a value of $120,000. John decides to take a distribution of $20,000

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[119] IRC §72(b)(3)(B). For purposes of determining if the individual has a net operating loss, the deduction is treated as if it were attributable to a trade or business. IRC §72(b)(3)(C)

[120] Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), *supra*. *See* S. Rep. No. 97–494(I), 97th Cong., 2d Sess., at 640 (1982). *See also* TRA '86 Senate Explanation, Section 1123. "[T]he Committee also believes that tax incentives for retirement savings are inappropriate unless the savings are not diverted to nonretirement uses. One way to prevent such a diversion is to impose an additional income tax on early withdrawals from tax-favored retirement savings arrangements in order to discourage withdrawals and to recapture a measure of the tax benefits that have been provided."

[121] IRC §72(q)(1)

from the annuity. In addition to the ordinary income tax that John must pay on the $20,000 gain in the contract, he will also have to pay another $2,000 in additional tax because he is under age 59½ and does not qualify for one of the exceptions to the application of the 10% penalty tax. Depending on the terms of the annuity, he may also have to pay surrender charges on some of the distribution. Unfortunately, John may not deduct the cost of the surrender charges when calculating either the gain in the contract or the 10% penalty tax.[122]

2. Exceptions to the General Rule

According to the Internal Revenue Code, *all* withdrawals are subject to the 10% penalty tax. The Code then carves out a number of exceptions.[123] It is important to remember the sequence. You should begin any analysis with the assumption that *all* withdrawals are subject to the 10% penalty tax unless there is an exception.

Note If a non-natural owner is *not* treated as an agent for an individual (and therefore is not allowed to defer the taxation of annuity earnings), that owner is not subject to the 10% penalty tax. If a non-natural owner is treated as an agent for an individual (and therefore is allowed to defer the taxation of annuity earnings), that owner is subject to the 10% penalty tax unless an exception applies.

a. Distributions Received After the Annuity Owner (*Not* the Annuitant) Reaches Age 59½[124]

For individuals, this is the defining condition for a premature distribution, and the IRS administers it that way. The owner's age is the determining factor. The law considers the owner (the taxpayer) to be the income recipient – even if he is not.

Example 31. 10% Federal Penalty Tax and Joint owners

Mom and Dad are joint owners of an annuity. Mom is under age 59½ and Dad is older. They take money out of the annuity. Do they qualify for the age 59½ exception? Who is the taxpayer? For reporting purposes, each owns half of the annuity.[125] Because Dad is over age 59½, his 1099-R will reflect that his share of the withdrawal is not subject to the 10% penalty tax. Because Mom is under age 59½, hers will reflect that she must pay the 10% penalty tax.

Distributions from annuities owned by a non-grantor trust to the trust that are then distributed to an individual beneficiary generally qualify for this exception if the beneficiary is at least age 59½.[126]

Distributions from annuities owned by a grantor trust (as in the case of the usual revocable "living" or "family" trust) are not subject to the 10% penalty tax if the grantor is at least age 59½.[127]

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[122] IRC §72(e)(3)
[123] IRC §72(q)(2)
[124] IRC §72(q)(2)(A)
[125] IRC §72(q)(2)(A). IRS *Form 5329 Instructions* require both husband and wife to file that form if both separately received premature distributions that they cannot report on Line 57 of their Form 1040.
[126] According to the H.R. Conference Report No. 99-841 (TRA '86) reprinted 1986-3 CB 401, an annuity contract held in trust by a non-natural person for a natural person beneficiary will be treated as though the beneficial owner were the holder of the annuity contract. The character of distributed income items carries over to the beneficiary, Reg. §§1.652(b)-1 and 1.662(b)-1, who becomes the "taxpayer" with respect to such items.
[127] In a grantor trust, the person who set up the trust (the "grantor") pays tax on trust income.

Distributions from annuities owned by other non-natural persons never qualify for this exception unless the owner is treated as an agent of a real person.[128] Distributions are subject to the 10% penalty tax unless the distributions qualify under another exception. If the owner and annuitant are different, the age of the owner determines whether the exception is available.

Example 32. Annuitant Over Age 59½

John, age 50, owns an annuity. Matt, age 82, is the annuitant. If John takes money out of the annuity, he will pay the 10% penalty tax because he is under age 59½.

Example 33. Owner Over Age 59½

Melinda, 60, owns an annuity. Her granddaughter, age five, is the annuitant. Because she is older than age 59½, Melinda can take money out of the annuity without paying the 10% penalty tax.

b. Distributions After Death of Owner

Distributions made after *any* owner dies escape the 10% federal penalty tax. That is not true of distributions made when an annuitant dies. The exception is if the owner is not an individual, then the death of the primary annuitant (or a change in the primary annuitant[129]) triggers the exception.[130]

Example 34. Distributions after Death

Scott owns an annuity and is the annuitant. His son, Adam, is the beneficiary. Scott dies and Adam, age 50, decides to take the money over five years. The distribution of the annuity value itself is not subject to the 10% penalty tax.

Example 35. Owner Dies.

Sean (age 50) buys an annuity and names himself as the owner. He names his daughter, Julia, (age 25) as the annuitant and primary beneficiary. Sean dies five years later at age 55. The insurance company must pay a death benefit to Julia payable either (1) immediately, (2) within five years of Sean's death or (3) in the form of a life annuity based on Julia's age. Payments will be income taxable to Julia as she receives them. However, even though Sean was less than age 59½, there will be no 10% penalty tax because the distributions are made because of the death of an owner.[131]

Example 36. Annuitant Dies

Same example as above, except that Julia dies five years later at age 30, instead of Sean. The annuity requires the insurance company to pay a death benefit to the owner on the death of an annuitant. The death benefit may be added to the annuity value without being distributed, thereby creating no taxable income event. If the owner later decides to take distributions from the annuity, the death

[128] If a corporation owns an annuity, it is not treated as an annuity for federal income tax purposes. TRA '86 Committee Reports to Section 1035, adopting IRC §72(u). The purpose of the 10% penalty tax is to discourage the use of annuities as short-term vehicles and to recapture the tax benefits of deferral. Neither of these purposes is served by imposing the 10% penalty tax on premature distributions from corporate-owned annuities. There is no tax deferral if a corporation owns an annuity. Hence, there is no tax benefit to the corporation.
[129] IRC §72(s)(7)
[130] IRC §72(q)(2)(B)
[131] IRC §72(q)(2)(B)

benefit paid because of the annuitant's death is treated as gain for income tax purposes. The 10% penalty tax should apply to the taxable portion of the distribution if the owner is under age 59½ when distributions are made. Note that the 10% penalty tax is not waived when Julia dies. It is the owner's death that triggers an exception to the 10% penalty tax.

Planning Idea Sean may be able to structure his payments in a way that satisfies another exception to the 10% penalty tax on premature distributions. For example, he might be able to set them up as substantially equal periodic payments over his life expectancy.

c. Disability

Distributions to an owner who is disabled are not subject to the 10% federal penalty tax.[132] The disabled person must be the owner of the annuity.[133]

Example 37. Distributions to a Disabled Owner

Mom buys an annuity and is the sole owner. Dad later becomes disabled. Because Mom is the owner and is *not* disabled, the exception does not apply to her. Mom transfers the annuity to Dad, who is 50. Because they are married, the transfer does not create a taxable event.[134] Dad, now the owner, may take withdrawals without paying the 10% penalty tax.

Note The statute speaks in terms of distributions "attributable to the taxpayer's *becoming* disabled [emphasis supplied]." Some interpret this as meaning that the disabled person must own the annuity *before* becoming disabled. The legislative history to the qualified plan counterpart to the 10% penalty tax, however, states that Congress did not intend the 10% penalty tax to apply to "*distributions made after the recipient became disabled* [emphasis supplied]." There is no reason to believe Congress intends a different standard for non-qualified annuities.[135]

d. Distributions From An Annuity Bought By An Employer

Distributions from an annuity bought by an employer on the termination of a 401(a) or 403(b) plan.[136] The employer must continue to own the annuity until the employee separates from service.[137]

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[132] IRC §72(q)(2)(C)

[133] The Committee report says, "… [T]he penalty will not apply to a distribution that is… (3) attributable to the policyholder *becoming* disabled…" [emphasis supplied]

[134] There is an unlimited gift tax deduction between spouses. There is no income tax because IRC §72(e)(4)(C)(ii) exempts this transaction from the usual rule.

[135] As noted in Priv. Ltr. Rul. 9318043, "The Legislative History of section 2002(b) of the Employee Retirement Income Security Act of 1974 (Pub. L. No. 93–406) which, in part, added sections 408(f)(1) and (3) to the Code, provides, in pertinent part, that the 10% additional income tax was not applicable to IRA distributions made after the recipient became disabled. (*See* House Report 93–779, 93rd Congress, 2nd Session 32, 1974–3 C.B. 275, and House Report 93–807, 93rd Congress, 2nd Session 138, 1974–3 C.B. Supplement at page 373.)" *See* also Priv. Ltr. Rul. 9249034.

The exact language provides an exception to the 10% penalty tax "attributable to the taxpayer's becoming disabled within the meaning of IRC §72(m)(7)." IRC §72(m)(7) defines disability to mean that a person "is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or to be of long-continued and indefinite duration."

[136] IRC §72(q)(2)(E)

[137] IRC §72(q)(2)(J)

e. **Pre-TEFRA Annuities**

Distributions allocable to basis before August 14, 1982.[138]

f. **Structured Settlements**

Distributions from structured settlement annuities.[139]

g. **Retirement Plan Investments**

Distributions made from an annuity owned by a qualified plan, a 403(b) annuity, or from an IRA.[140] These plans have their own penalties for premature distributions.

h. **Immediate Annuities**

Distributions from immediate annuities are not subject to the 10% federal penalty tax on premature distributions.[141] This also applies to annuitizations from immediate annuities that take the form of a period certain. It is not limited to life expectancy annuitizations (including substantially equal periodic payments discussed below).

Trap An exchange of a deferred annuity for an immediate annuity does *not* qualify for the immediate annuity exception to the 10% penalty tax (even though it is a valid 1035 exchange). The IRS has ruled that if a deferred annuity is exchanged for an immediate annuity, the original purchase date of the deferred annuity is also the purchase date of the new annuity. Because an immediate annuity is one in which annuity payments begin within one year of purchase, the actual annuity purchase date is critical for purposes of this exception.[142] Here payments from the immediate annuity do not qualify because they begin more than a year after the purchase date of the original deferred annuity. This may be a distinction without a difference if the immediate annuity is annuitized over life expectancy because the payments may still qualify under the substantially equal periodic payment (SEPP) exception for life expectancy payments, or under another exception.

Example 38. 1035 Exchange of a Deferred Annuity for an Immediate Annuity

John bought a deferred annuity in 2000 when he was 55. Three years later, he exchanged it for an immediate annuity that began lifetime systematic payments 3 months after the exchange. The purchase date of the new annuity for purposes of the 10% penalty tax is the date he bought the deferred annuity. Payments from the replacement annuity do not fall within the immediate annuity

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[138] IRC §72(q)(2)(F)
[139] IRC §72(q)(2)(G)
[140] IRC §72(q)(2)(H)
[141] IRC §72(q)(2)(I) within the meaning of IRC §72(u)(4).
[142] IRC §72(u)(4); Rev. Rul. 92–95, 1992–2 C.B. 43. Neither IRC §72(u)(4) nor Rev. Rul. 92–95 makes a distinction between period certain and life contingent immediate annuities. A 1035 exchange of a deferred annuity for an immediate period certain annuity would be caught in this trap because the owner is trying to take a payment that does not fall within one of the exceptions in IRC §72(q). But a 1035 exchange to an immediate life annuity would not be caught, not because it qualifies as an immediate annuity (it does not under the reasoning in Rev. Rul. 92–95), but because it satisfies the distribution over life expectancy exception in IRC §72(q). Furthermore, a loophole to the reasoning in Rev. Rul. 92–95 is the case of a deferred annuity exchanged for an immediate annuity within one year of the purchase of the annuity, and where payments under the immediate annuity also begin within one year of the purchase of the deferred annuity purchase date.

exception.[143] However, they presumably would qualify as a series of substantially equal period payments, discussed next.

i. Substantially Equal Periodic Payments

Distributions that are a part of a series of substantially equal periodic payments (SEPPs).[144] For those under age 59½, this may be the easiest way to avoid the 10% penalty tax. If the annuity allows systematic withdrawals, those withdrawals may satisfy the rules – but only if they meet the requirements below.[145] A 2002 IRS Ruling made significant changes in the rules for SEPPs from qualified annuities.[146] In 2004, the IRS made those changes applicable also to non-qualified annuities.[147]

(1) Qualifying Standard

To qualify as a SEPP, distributions must be made:

- At least annually, and
- For the life or life expectancy of the owner or the owner and a named beneficiary.[148]

(2) Three Calculation Methods

There are three ways you may calculate the required payment.[149]

- The required minimum distribution method.
- The fixed amortization method.
- The fixed annuitization method.

Each method results in a different required payment. The fixed annuitization method usually results in the largest payment. The required minimum distribution method usually results in the smallest payment. The required minimum distribution and fixed amortization methods may be based upon one of the following.

- The single life of the owner (using the single life table).
- The joint life expectancy of the owner and an imaginary designated beneficiary 10 years younger than the owner (using the uniform life table).
- The joint life expectancy of the owner and an actual beneficiary using the joint life and last survivor table.

The fixed annuitization method is based only on the single life of the owner.

Resource The Genworth Advanced Marketing Team's website has a web calculator that does the first two of the three calculations listed

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[143] Rev. Rul. 92–95, *supra*
[144] IRC §72(q)(2)(D)
[145] Systematic withdrawals under an annuity can be an attractive alternative to annuitization because the accumulation value of the annuity remains available for surrender if the owner has unexpected liquidity needs. The downside risk, however, is that the owner will "outlive his money." The accumulation value of the annuity could be exhausted before the owner dies, a risk that is avoided with life annuitization. Systematic withdrawal may be a good alternative to annuitization in pre-retirement years because the owner still has the cash value of the annuity if he needs money later. Once you have annuitized the contract, most annuity contracts no longer allow the annuity to be commuted into cash, or permit withdrawals.
[146] Rev. Rul. 2002–62, 2002–42 I.R.B. 710, *modifying* Notice 89–25, 1989–1 C.B. 662
[147] Notice 2004–15, 2004–9 I.R.B. 526
[148] IRC §72(q)(2)(D)
[149] The DEFRA Bluebook, *supra* at 364 says "The requirement that the amount be paid out as one of a series of "substantially equal" periodic payments is met whether it is paid as part of a fixed annuity, or as part of a variable annuity under which the number of units withdrawn to make each distribution is substantially the same."

above. You can access this through [Genworth's Financial Pro website at pro.genworth.com]() Look for a link to "Advanced Marketing."

The calculations of the fixed amortization method and the fixed annuitization method involve the use of a "reasonable" interest rate. That rate can be no higher than 120% of the annual applicable federal mid-term rate from either of the two months before the first distribution.[150] The maximum rate is always available on the web calculator on the Advanced Marketing website.

SEPPs are treated as partial surrenders from the annuity. Surrender charges may also apply.

Genworth If asked, Genworth will calculate the SEPP payments based upon the fixed amortization method, the fixed annuitization method, or the required minimum distribution method.

Caution The contractual right to withdraw money from an annuity – even if structured as a systematic withdrawal – is not the same as a SEPP. That distribution may avoid surrender charges, but it may not qualify as a SEPP because it may not be based on life expectancy or may not otherwise meet the requirements of the three allowable methods to compute SEPPs.

(3) Changing the Amount Paid Under SEPPs

Once an owner begins receiving SEPPs, if the owner makes any change in the payments before the *later* of reaching age 59½, or five years after the first payment, the owner will generally have to pay the 10% penalty tax on all distributions back to the first payment. In addition, the owner will have to pay interest on the 10% penalty tax owed for earlier years. [151]

The IRS allows those who are already receiving SEPPs to make a one-time, irrevocable change from either the fixed annuity or the fixed amortization method to the required minimum distribution method.[152] This reduces the payment amount when the annuity value in a variable annuity declines because of market losses.

Caution Any withdrawal other than the calculated SEPP payment is a modification and will trigger the 10% penalty tax.

Caution If SEPPs are being taken from an annuity, the IRS treats an exchange of that annuity contract under Section 1035, even though otherwise tax-free, as a modification of the 72(t) distributions.[153]

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[150] Rev. Rul. 2002–62, *supra, modifying* Notice 89–25, supra.

[151] IRC §72(q)(3). According to the TRA '86 Conference Committee, the modification that triggers recapture is a change to a method of distribution that would not qualify for the exemption. The tax on the amount recaptured is imposed in the first taxable year of the modification and is equal to the tax (as determined under regulations) that would have been imposed (plus interest) had the exception not applied. H.R. Conf. Rep. No. 99–841 (TRA '86) reprinted in 1986–3 C.B. Vol. 4 403.

[152] IRS Notice 2004–15, *supra,* extending to non-qualified annuities the option the IRS gave to qualified annuities in Rev. Rul. 2002–62, *supra.*

[153] See Rev. Rul. 2002-62, 2002-2 C.B. 710. Section 2.02(e) says that "any nontaxable transfer of a portion of the account balance to another retirement plan" is a modification of the distributions. Notice 2004–15, *supra*, extended to non-qualified annuities the methods outlined in Rev. Rul. 2002-62 to create a series of substantially equal periodic payments."

Example 39. Distributions Before Age 59½

Cheryl, age 49, wants to use her $70,000 annuity for additional income. The annuity method lets her take $6,000 a year without paying the 10% penalty tax. She generally cannot change this payment stream until she is age 59½ without paying the 10% penalty tax. If she had been 58 when the payments began, she may not change the payments until she is 63 (i.e., the later of age 59½ and 5 years after the first distribution) without paying the 10% penalty tax.

B. Section 1035 Exchange

1. General Rule

IRC §1035 allows the owner of an annuity to exchange one annuity for another annuity, within certain limits, without currently having to pay tax on the gain in the annuity. The tax liability that would otherwise be recognized is deferred. This is called a 1035 exchange. To qualify as a tax-free exchange, the transaction must meet certain criteria, and the insurance companies must process it properly.

An exchange under IRC §1035 is not elective once the exchange is made. After the insurance company has processed the exchange to satisfy the IRC criteria, the exchange is a 1035 exchange. The contract holder cannot elect to recognize the loss or income from the exchange if he or she later finds that the "non-recognition" feature of the 1035 exchange is undesirable. One should be especially careful of implementing a 1035 exchange in cases where a replaced contract has lost value. If a new contract is desired, the old contract may be surrendered and the cash received from surrender may be used to purchase a new contract.[154] This loss on the surrender of the old contract possibly may be recognized by the owner. See Section V.D, "Losses on Annuities Surrendered or Sold" on page 20 of this outline.

A replacement may not be in the best interest of a client. For example, a client may incur surrender charges for leaving the old product and/or a new extended surrender charge period on the new annuity. Representatives should carefully consider whether a replacement is in the best interest of their client before making a recommendation to replace the client's existing product.

2. Exchanges That Are Allowed

Unless the exchange is specifically allowed in IRC §1035, it will be treated as a distribution and will be taxed as a surrender.[155]

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[154] However, cash cannot be received by the contract holder before the purchase of the new contract. Rev. Rul. 2007-24 held that if a taxpayer received a check from a life insurance company from surrender of a nonqualified annuity contract, and then endorsed the check to a second company as consideration for a second annuity contract, then the transaction did not qualify as a tax-free exchange under IRC section 1035(a)(3). See also, Priv. Ltr. Rul. 200622020 which held that (1) a taxpayer could not rollover tax free the amount distributed by an insurance company to her joint revocable trust in surrender of a non-qualified annuity contract after the joint grantor died, (2) nor could the taxpayer claim that she made a constructive tax free exchange of the contract under IRC §1035 of the Revenue Code if she reinvested the distributed proceeds in a new annuity contract.

[155] IRC §1035(b)(2). The legislative history of IRC §1035 states that exchange treatment is appropriate for "individuals who have merely exchanged one insurance policy for another better suited to their needs and who have not actually realized gain." H.R. Rep. No. 1337, 83rd Cong., 2nd Sess. 81 (1954). The distinction between an exchange and a surrender and purchase of a new annuity is sometimes murky. The following exchanges have met with IRS approval. The exchange of one annuity for a second annuity with a term life insurance rider attached. Priv. Ltr. Rul. 200022003. Where an owner transferred directly a portion of the funds in one annuity to a second newly issued annuity. *Conway v. Comm'r*, 111 T.C. 350 (1998), *acq.* 1999–2 C.B. xvi. An assignment of an annuity for consolidation with a pre-existing annuity. Rev. Rul. 2002–75, 2002–2 C.B. 812. The exchange of a life insurance policy, endowment contract, or fixed annuity for a variable annuity. Rev. Rul. 72–358, 1972–2 C.B. 473; Rev. Rul. 68–235, 1968–1 C.B. 360. The assignment of an annuity to another insurance company for a new annuity

The following exchanges are tax-free.

- A life insurance policy for another life insurance policy, or for an endowment policy, or for an annuity.
- An endowment policy for an annuity, or for an endowment policy under which payments will begin no later than the date payments would have begun under the endowment policy exchanged.
- One annuity for another annuity.

3. Obligee Must Be the Same

For an annuity exchange to be tax-free, the obligee or obligees of the original annuity must be the same person or persons under the new annuity.[156]

An obligee is a person to whom the insurance company owes an obligation. The identity of an obligee depends on the terms of the annuity contract, and may change as the rights of the parties change over the life of the annuity.

Genworth Under most annuity contracts issued by the Genworth Financial companies, the obligee is the owner until the annuity's maturity date. Until then, the annuitant has no rights in the annuity. After the annuity's maturity date, the annuitant may have different rights if he is then also the payee. The owner of the new annuity must be the same as the owner of the old annuity.

Example 40. 1035 Exchange of Single Owner Annuity to Single Owner Annuity

Brian is the owner and annuitant of a fixed annuity with a cash surrender value of $100,000 and a basis of $70,000. He exchanges this fixed annuity for a variable annuity properly following the 1035 exchange procedures of the companies. He is the owner and annuitant of the new annuity. Brian does not have to pay tax on any gain in the old annuity and his basis remaining in the new annuity will be $70,000.

Example 41. 1035 Exchange of Life Insurance Policy to Annuity with Joint Annuitants

Kristi is the owner and insured under a life insurance policy with $250,000 in current cash value. She wants to exchange the life insurance policy for an annuity with her as owner and with both her and her husband as annuitants.

Genworth This is a gray area because the Code and IRS regulations are silent. IRC §1035 does not require the insured of the exchanged life insurance policy to be the obligee on the new annuity. However, an implicit requirement in the case of all tax-deferred exchanges is that the property exchanged and received in the exchange belongs to the

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was an exchange. Rev. Rul. 72–358, *supra.* The surrender of a nonassignable annuity distributed by a pension trust and immediate endorsement of the check by the owner to a new insurer in a single integrated transaction under a binding exchange agreement with the new insurance company was an exchange. Priv. Ltr. Rul. 8526038, 8501012, 8344029, and 8343010. However, where the annuity was assignable, the IRS required a direct transfer of funds between insurance companies. *See* Priv. Ltr. Rul. 8741052. *Compare* Priv. Ltr. Rul. 8515063 and 8310033. Where multiple transactions are involved, the IRS viewed them as one integrated exchange. The taxpayer bought an annuity and later withdrew an amount equal to his basis. He put that money into a single premium life insurance policy. Next, he exchanged the annuity for another annuity and treated this part of the transaction as a tax-free exchange. The IRS characterized the events as a single exchange and said the taxpayer received the value of the life insurance policy as taxable boot, i.e., money or other property. Priv. Ltr. Rul. 8905004. *See also* Priv. Ltr. Rul. 9141025.

[156] Reg. §1.1035–1

same taxpayer. Genworth believes this is a permissible exchange under IRC §1035 if the exchange occurs before the annuity starting date.

Example 42. 1035 Exchange of Life Insurance Policy to Annuity with Annuitant Other Than Insured

Jennifer owns a life insurance policy with Gwen as the insured. She wants to exchange the life insurance policy for an annuity where she will be the owner, but someone other than Gwen will be the annuitant. It might be Jennifer, but it could also be their friend Michelle. Is this a valid 1035 exchange? The answer is again unclear. An annuitant is not an insured. One may argue that there is no policy justification for denying IRC §1035 treatment. By surrendering the policy and annuitizing the surrendered proceeds, Jennifer has transformed potentially tax-free amounts (the life insurance death benefit) into tax-deferred amounts (the annuity payments).

Genworth Genworth believes that this is a permissible exchange under IRC §1035. Genworth will accept this business, with full disclosure, if the customer acknowledges the tax uncertainty in writing.

4. Partial 1035 Exchanges

In 2002, the IRS issued guidance on exchanges where only part of the annuity value is transferred in a 1035 exchange. A pro-rata share of the basis in the replaced annuity is transferred to the new annuity. That guidance limited the distributions that could be taken from either the old or from the new annuity within 24 months of the partial exchange.[157]

Example 43. Partial 1035 Exchange of Annuity

Adriann owns an annuity issued by Company B. She is the obligee under that annuity. Adriann assigns 60 percent of the cash surrender value in the old annuity to Company C in exchange for a new annuity. She never has access to the cash surrender value of the old annuity that was transferred to Company C. The terms of the old annuity are unchanged by this transaction, and it is not treated as newly issued. Adriann's basis in the new annuity is 60 percent of her basis in the old annuity before the exchange. Her basis in the old annuity is 40 percent of its basis at that time.

In early 2008, the IRS attempted to end a practice that had developed under the 2002 guidance. There were potentially two ways to access money from an annuity contract created in a partial 1035 exchange before the 24-month period had expired. One way was to do a partial 1035 exchange into an immediate annuity and begin taking annuity income. Another was to take substantially equal periodic payments from one of the annuities resulting from the exchange. The new guidance specifically prohibits this practice. At the same time, it reduced the 24-month period to 12 months.[158]

The IRS has said that it is studying partial annuitization, and has placed it on its "no rule" list while it studies the issue.

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[157] Rev. Rul. 2003–76, 2003–33 I.R.B. 355; Notice 2003–51, 2003–33 I.R.B. 361, superseded by Rev. Proc. 2008-24, 2008-13 I.R.B. 684.
[158] Rev. Proc. 2008-24, 2008-13 I.R.B. 684

5. **IRS Reporting Requirements**

The old (replaced) insurance company must file a Form 1099-R in a 1035 exchange[159] unless it is an internal exchange that meets certain requirements.[160]

Genworth If an exchange is only partly tax-free, Genworth issues two 1099-Rs.

Caution Exchanges of annuities issued by affiliated insurance companies are *not* internal exchanges and must be reported.

6. **Investment in the Original Contract Becomes Basis in New Annuity**

The basis of the old annuity is transferred to the new one. To prevent creating basis (if the replaced annuity had gain) or destroying basis (if the replaced annuity suffered investment losses), the replacing insurance company must be willing to accept the basis calculations of the original insurance company. If the original insurance company does not share basis information, the replacing insurance company must report distributions from the new annuity as "taxable amount not determined."

Example 44. Consolidation of Two Annuities

Kevin owns two annuities issued by different insurance companies (Company A and Company B). He wants to consolidate the annuities without recognizing any gain by transferring the annuity issued by Company A into the annuity issued by Company B, under IRC §1035. His basis in the new annuity is equal to the sum of his investment in both contracts before the exchange.[161]

Example 45. 1035 Exchange of Permanent Cash Value Type Life Insurance Policy for Annuity

Rebecca owns a universal life insurance policy issued by Company A. It has a basis of $50,000. She wants to exchange the life insurance policy for an annuity issued by Company B. This qualifies as a 1035 exchange. Her basis in the annuity is equal to the original $50,000 basis in the life insurance policy.

Example 46. 1035 Exchange of Term Life Insurance Policy for Annuity

Deborah owns a term life insurance policy issued by Company A. She has paid $50,000 in premiums on that policy. She wants to exchange the life insurance policy for an annuity issued by Company B. This may qualify as a 1035 exchange, even though there is no gain in the term life insurance policy. Her basis in the annuity depends on the basis reported to Company B by the first company. If it reports the basis as the $50,000 premiums Deborah paid for the life insurance policy, her basis in the annuity will be $50,000. However, some companies choose to take a more conservative approach. If Company A is one of those, it might report her basis as only the current year's premium or even as zero. Whatever amount Company A reports to Company B, Company B will have to accept as the basis transferred into Deborah's annuity.

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[159] IRS *2007 Instructions for Forms 1099-R and 5498,* R-5. The total paid into the new annuity is shown in Box 1. The taxable amount in box 2a is zero. The premiums paid on the old policy are in box 5. There is a 6 in box 7 indicating this is a tax-free exchange.
[160] *See* IRC §6047(d). Rev. Proc. 92–26, 1992–1 C.B. 744. IRS *2007 Instructions for Forms 1099-R and 5498, R-5.* The exchange may not result in a distribution of boot and the insurance company's records must be sufficient to determine the owner's basis.
[161] IRC §72(c)(1). *See,* e.g., Rev. Rul. 2002–75, *supra*

Note In any case, it is up to Company A (the life insurance company) to report the basis in the life insurance policy to the insurance company issuing the annuity (Company B). Company B cannot use the life insurance policy's basis as the starting point for the annuity's basis unless Company A reports it. Company B must accept the reported basis provided by Company A.

Example 47. 1035 Exchange of Life Insurance Policy without Cash Surrender Value for an Annuity

Diane bought a variable universal life insurance policy in 1997 and paid minimum premiums totaling $144,000. Because of the contractual surrender charges, the payment of minimum premiums and a decline in the value of the subaccounts she selected, if she surrenders the policy she will receive nothing. She would like to do a 1035 exchange into an annuity and will pay an additional $25,000 premium into the annuity. This is a valid 1035 exchange.

Comment It is not important that the life insurance policy has no cash surrender value, but it must be in force. If the life insurance company reports Diane's basis in the life insurance policy as $144,000, her starting basis in the annuity will be $169,000 ($144,000 plus $25,000). The initial annuity value will be $25,000 (less any applicable fees and charges).

7. Other Considerations

a. New Surrender Charges May Apply

When doing a 1035 exchange, note that a *new* annuity *is* created. Though the initial rate on a new annuity may be attractive, the annuity may be subject to new surrender charges. Also, the exchange of an existing annuity before the end of *its* surrender charge period may mean that the owner must pay a surrender charge to exchange the existing annuity.

b. Exchange After Owner Dies

May a beneficiary or successor owner do a 1035 exchange within five years after the original owner dies but before a complete distribution of the annuity? There is no clear answer.[162]

c. Exchange of a Deferred Annuity for an Immediate Annuity

This is allowable under IRC §1035. However, it may create a problem for purposes of the premature withdrawal rules. See the discussion in Section VIII.A.2.h on page 38.

d. Loss of Step Up in Basis in Older Annuities

See Section VII.E.3 on page 32.

e. Exchange of Pre-TEFRA Annuity

Premiums paid before August 14, 1982, continue to be treated as pre-TEFRA money. Distributions, up to the owner's investment in the contract, are a return of principal and are not taxed. The owner must pay tax on any distributed taxable income that is

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[162] Generally, if the owner dies before the annuity's maturity date, the entire interest in the annuity must be distributed within five years after the death of the owner. IRC §§72(s)(1)(A) & (B)

attributable to the pre-TEFRA premiums, but that income is not subject to the 10% federal penalty tax.[163]

f. Exchange With a Non-U.S. Insurance Company

The exchange of an annuity issued by a U.S. insurance company for an annuity issued by a non-U.S. insurance company may not qualify as a tax-free exchange under IRC §1035.[164]

Genworth Genworth will issue a Form 1099-R to report the distribution as "taxable amount, not determined."

g. Exchange of Annuity Subject to Substantially Equal Periodic Payments

The tax-free exchange under Section 1035 of an annuity from which distributions of substantially equal period payments are being taken may be treated as a modification of the SEPPs. That would cause all distributions to be retroactively subject to the 10% penalty.[165]

C. Gift of an Annuity to Charity

A gift of an annuity to a qualifying charity entitles the owner to a charitable income tax deduction. It will also, however, be treated as a complete surrender of the annuity, taxable to the extent of any gain in the annuity.[166]

1. Annuities Issued Before April 23, 1987

If the owner gives a matured annuity to charity, then in that year (including the year when the annuity matures), tax law treats the gift as a complete surrender of the annuity. The owner must pay income tax on any gain in the annuity.[167] She may, however, take a charitable income tax deduction for the full value of the annuity, subject to other limitations imposed on charitable deductions.[168] If the owner makes the gift in a year *before* the annuity's maturity date, she does not pay income tax on any gain in the annuity. However, she may deduct *only* her investment in the contract as a charitable gift.[169]

2. Annuities Issued After April 22, 1987

Tax law treats the owner as making a complete surrender of the annuity in the year he makes the gift and the owner must pay income tax on any gain in the annuity.[170] He may deduct the entire annuity value as a charitable gift, subject to other limitations imposed on charitable deductions.[171]

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[163] IRC §72(q)(2)(F). Rev. Rul. 85–159, *supra,* Priv. Ltr. Rul. 9442030. Investment in the replacement annuity is considered made on, before, or after August 13, 1982, to the same extent the investment was made on, before, or after August 13, 1982, in the replaced annuity.

[164] Although Priv. Ltr. Rul. 9319024 approves such an exchange, changes to IRC §1031 in 1997 (Pub. L. No. 105–34). Section 1052(a) of that law said that "domestic use property" and "foreign use property" were not like-kind. *See also* IRC §1035(c).

[165] See Rev. Rul. 2002-62, 2002-2 C.B. 710. Section 2.02(e) says that "any nontaxable transfer of a portion of the account balance to another retirement plan" is a modification of the distributions. Notice 2004–15, *supra*, extended to non-qualified annuities the methods outlined in Rev. Rul. 2002-62 to create a series of substantially equal periodic payments."

[166] IRC §72(e)(4)(C)

[167] *Friedman v. Comm'r,* 15 AFTR 2d 1174 (CA6 1965); Rev. Rul. 69–102, 1969–1 C.B. 32

[168] Reg. §1.170A-4(a)

[169] IRC §170(e)(1)(A); Rev. Rul. 69–102, *supra*

[170] IRC §72(e)(4)(C)

[171] Reg. §1.170A-4(a)

D. Non-Charitable Gift of an Annuity

A gift is a transfer of property for less than full and adequate consideration. When an interest in an annuity is transferred as a gift, there may be income and gift tax consequences to the donor.

1. Gift of the Annuity Payments

The owner of an annuity cannot avoid income tax on a taxable distribution. For example, he may not assign the right to receive annuity payments and avoid paying tax on the taxable part of those payments.[172] This rule applies to earnings both before and after the assignment. Such a gift may also result in gift tax.

2. Transfer of Ownership To or From a Trust

Normally, tax law treats the transfer of an annuity by gift the same as a complete surrender of the annuity followed by a gift of the proceeds to the donee. However, there are several exceptions.

- A transfer of an annuity to or from the owner's grantor trust (i.e. a revocable trust). It is the same taxpayer before and after the transfer.[173] However, some transfers to or from a grantor trust may not be permissible. [174]
- A transfer from an individual to a trust for his or her sole benefit, for example, to a "spendthrift trust".

Note Make sure the insurance company knows all the facts. Otherwise, it will probably report the transaction as taxable. The insurance company can later correct the 1099-R, if needed.

Genworth Unless told otherwise, Genworth assumes that the transfer of an annuity from one person to another or to an *irrevocable* trust for the benefit of another person is a *taxable* transfer and it reports the change for income tax purposes. This is also true if the trust does not use the owner's social security number as its taxpayer identification number.

3. Gift or Transfer of Post-April 22, 1987 Annuity

If an *individual* owner gives or transfers an annuity without receiving adequate consideration, he is taxed to the extent of gain in the annuity. Essentially, tax law treats the transfer as a complete surrender followed by a gift of cash.[175]

There are exceptions to this rule.

- Transfers between spouses.
- Transfers between existing non-spousal joint owners.

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[172] *See Helvering v. Eubank,* 311 U.S. 112 (1940); *Lucas v. Earl,* 281 U.S. 111 (1930); *Van Brunt v. Comm'r,* 11 BTA 406 (1928)

[173] Priv. Ltr. Rul. 9204010 and 9204014. The taxpayer with respect to income received from the annuity did not change.

[174]*See*, Priv. Ltr. Rul. 200622020 which held that (1) a taxpayer could not rollover tax free the amount distributed by an insurance company to her joint revocable trust in surrender of a non-qualified annuity contract after the joint grantor died, (2) nor could the taxpayer claim that she made a constructive tax free exchange of the contract under IRC §1035 of the Revenue Code if she reinvested the distributed proceeds in a new annuity contract. In this case one of the grantors of the trust died. Pursuant to IRC §72(s)(1) , when the holder of an annuity contract dies, the contract must be distributed to the beneficiary. The beneficiary was the trust, and the surviving spouse could not exercise continuation rights. Although the issues in this case largely centered on IRC §1035, this ruling nevertheless indicates that a grantor trust may not always be in the same tax position as an individual taxpayer. Cases like these may often turn on the trust language, annuity contract language, and the facts of the specific case.

[175] IRC §72(e)(4)(C)(i). This rule applies only to gain properly allocable to post-August 13, 1982 basis.

- Additions of spouse as joint owner.
- Transfers due to divorce if the court mandates the change in the divorce decree.[176]
- Transfers from an owner to a grantor trust.
- Transfers from a corporation to an individual.
- Change due to court order.
- Changes or additions during the free look period.

4. Gift or Transfer of Pre-April 23, 1987 Annuity

The owner does not pay income tax when he makes the gift. However, if the donee later surrenders the annuity, the original owner pays (in that year) income tax on the amount of the gain that existed in the annuity on the date of the transfer that existed at the time of the gift. The donee pays income tax on the balance of any gain (the increase in value after the date of transfer).[177]

Example 48. Gift of Pre-April 23, 1987 Annuity

Robin bought an annuity and paid ten $2,000 annual premiums. She paid the last premium before April 23, 1987. In 2000, when the annuity value was $65,000, she gave the annuity to her son, Jack. Four years later, when the annuity value is $75,000, Jack surrenders the annuity. Robin has $45,000 of taxable income ($65,000 annuity value at the time of the gift minus her $20,000 investment in the contract). Jack has $10,000 of taxable income ($75,000 annuity value at the time of surrender minus $65,000 annuity value at the time of the gift). If Jack does not meet any of the exceptions for the 10% penalty tax, he must pay it as well.

5. Special Considerations

A transfer of an annuity by an individual owner to a corporation or partnership in return for an interest in that entity is not a gift.

An annuity distributed from a trust to a trust beneficiary is not treated as a deemed distribution because a trust is not an individual.[178]

If the donee agrees to pay the donor's gift tax liability, the donor has taxable income in the year the donee pays the gift tax to the extent the gift tax exceeds the donor's basis in the annuity.[179]

Generally, when a gift is made, the donee's basis is the same as the donor's basis before the gift. Additionally, the donee's basis may be increased by any amount that the donor included as taxable income when he made the gift.[180] The donee must reduce his basis by amounts received or deemed received before the annuity's maturity date (or the date

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[176] IRC §72(e)(4)(C)(ii). If related to a divorce, and if the annuity payable to the former spouse is transferred or assigned to the former spouse after July 18, 1984 (unless the transfer is pursuant to an instrument in effect on or before that date), legislative history states that the transferor "will be entitled to the usual annuity treatment, including recovery of the transferor's basis… notwithstanding that the annuity payments… qualify as alimony.…" DEFRA Bluebook, *supra* at p. 711. If both spouses so elect, the same treatment may be applied to a transfer made after December 31, 1983, and on or before July 18, 1984. When no gain is recognized, tax law treats the transferee as having acquired the annuity by gift. The transferor's basis is carried over to the transferee. IRC §1041. If the annuity is subject to a loan, there is income to the extent of gain. IRC §72(e)(4)(A)
[177] Rev. Rul. 69–102, *supra.* All premiums paid and excludable dividends received by both donor and donee before the annuity payments start are taken into account in determining basis. The annuity's maturity date and expected return are determined as though no transfer has taken place. Reg. §1.72–10(b)
[178] This may be inferred from the limited scope of the deemed distribution rule itself. *See also* Priv. Ltr. Rul. 9204010 and 9204014
[179] *Diedrich v. Comm'r,* 457 U.S. 191, 102 S. Ct. 2414 (1982); *Estate of Weeden v. Comm'r,* 685 F. 2d 1160 (CA9 1982)
[180] IRC §72(e)(4)(C)(iii)

on which the owner received an annuity payment if later) to the extent those amounts were not taxed.[181] Neither the annuity's maturity date nor its expected return change.[182]

Example 49. Basis on Gift of Annuity.

Dick pays premiums of $4,000 per year to a variable annuity for 10 years. In 2004, when the annuity value is $65,000, Dick gifts the annuity to his daughter, Leighsa, to help her pay college expenses. Dick has taxable income of $25,000 ($65,000 minus $40,000). Leighsa's basis in the annuity is $65,000. If Dick does not meet any of the exceptions for the 10% penalty tax, he must pay it as well.

E. Sale of an Annuity

1. Tax Treatment of the Seller

When an owner sells an annuity, the owner has taxable income to the extent of gain in the contract. That taxable income is ordinary income, not capital gain income. It is treated as a complete surrender.[183] If the sale is after annuity payments begin, the owner's basis is reduced (but never below zero) by any part of the annuity payments that were a return of his investment in the contract.[184]

2. Tax Treatment of the Buyer

A buyer receiving annuity payments is generally taxed as the original owner would have been taxed. The buyer's basis is what he paid for the annuity plus any premiums paid after the transfer.[185]

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[181] IRC §72(e)(4)(C)(iii)
[182] Reg. §1.72–10(b)
[183] *See First Nat'l Bank of Kansas City v. Comm'r,* 309 F. 2d 587 (CA8 1962), *aff'g Katz v. Comm'r,* T.C. Memo 1961–270
[184] IRC §1021
[185] Reg. §1.72–10(a)

Appendix

Dates to Note

October 21, 1988	Multiple annuities treated as one
April 22, 1987	Transfer of ownership taxable
April 22, 1987	Death of one joint owner forces distribution
February 28, 1986	Non-natural persons lose tax deferral
January 18, 1985	Owner's death triggers death distribution
January 18, 1985	10% penalty tax on premature distributions
August 14, 1982	Income first withdrawal rule (LIFO)
October 21, 1979	Variable annuities do not receive stepped up basis at death

Major Legislation

***Tax Equity and Fiscal Responsibility Act* (TEFRA), Pub. L. No. 97–248**

As of August 13, 1982, TEFRA changed the income tax treatment of annuity withdrawals. Congress changed those withdrawals from FIFO to LIFO. Before 1982, all withdrawals from fixed annuities were considered principal first (FIFO) and not subject to income tax until the owner withdrew enough to begin taking interest. Since TEFRA, all withdrawals from fixed annuities are considered interest first (LIFO) for income tax purposes.

Deficit Reduction Act of 1984 (DEFRA), Pub. L. No. 98–369

DEFRA set a 5% penalty tax on all fixed annuity withdrawals before age 59½. Before then, there were no federal tax penalties to access the annuity value at early ages.

Tax Reform Act of 1986 (TRA '86), Pub. L. 99–514

TRA '86 increased the 5% tax on premature withdrawals to a 10% penalty tax.

Technical and Miscellaneous Revisions Act of 1988 (TAMRA), Pub. L. No. 100–647

TAMRA affects all annuities issued after October 21, 1988. It requires that if someone buys multiple fixed annuities from one insurance company within one calendar year, IRS will treat those multiple annuities as one single annuity for purposes of determining the taxable income of a partial withdrawal.

Social Security Act Amendments of 1983, Pub. L. No. 98–21

Effective in 1984, the Social Security Administration changed the rules for certain recipients of social security income. Certain individuals are subject to tax on a portion of their benefits.

Omnibus Budget Reconciliation Act of 1993 (OBRA '93), Pub. L. No. 103–66

Further complicated the social security taxation calculation by adding a second threshold for individuals of higher income.

Table of Authorities

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