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How are Qualified Annuities Taxed?

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Somewhere along the line, we all decided that when the universe was created, annuities were divided into two fundamental types—"qualified" annuities and "nonqualified" annuities. "Qualified" is the term used for annuities that are issued in connection with a qualified Code section 401(a) pension or profit-sharing plan, section 403(b) plan, section 457(b) plan, or individual retirement account or annuity (IRA), all of which receive special tax treatment under the Internal Revenue Code. These are sometimes collectively referred to as "qualified arrangements." In the March 2016 issue of *Taxing Times*, my partner, John Adney, described the basic rules for nonqualified annuities but shrewdly left for another day the rules for qualified annuities.[1]

My task for readers is to open the door to the world of qualified annuities and the tax rules that apply to them, but the *most important* lesson you should take away from this article is that there are many kinds of plans and arrangements under which qualified annuities are issued, and the rules governing them differ considerably. An individual retirement annuity is not subject to the same rules as an annuity issued to a profit-sharing plan. A group annuity issued to terminate a pension plan is not subject to the same rules as a 403(b) individual annuity sold to teachers at educational institutions. In fact, the tax-preferred character of a qualified annuity, and the various rules it must satisfy, tends to flow not from the rules governing the annuity, but rather from the tax preference given to the particular plan or arrangement under the Code.

THE TAX CODE'S MOST IMPORTANT EXCEPTION

I think of qualified arrangements as, essentially, the tax code's most important exception to the *constructive receipt* principle. A fundamental feature of our income tax code is that income from employment or investments is taxable in the year it is generated, and this is true whether or not an individual wants to spend the income the same year—that is, income is "constructively" received even if the individual decides to save the income for the future.[2] A related rule—the *economic benefit* rule—provides that if an individual receives income in the form of an irrevocable contribution to a trust or annuity for the benefit of the individual, the individual is taxed immediately on that contribution, even if the individual cannot immediately access the trust, because the individual enjoys the "economic benefit" of knowing the amount is protected for the future.[3] The various rules for qualified arrangements are all built around avoiding immediate inclusion of income, either by deferring income tax on compensation paid for employment, or by deferring income on earnings paid on amounts held in these arrangements. All of these qualified arrangements eventually result in taxable income, however.

Congress created these very favorable income deferral arrangements to encourage individuals to save for retirement, and to encourage employers to offer retirement plans. Unlike some other employee benefits, the deferral is not a permanent exclusion. In contrast, for example, amounts an employer spends for a health care plan for its employees is completely excluded from the employees' income; not so for its 401(k) plan, which will eventually be taxed.

EMPLOYER-BASED PLANS

Annuities are most commonly issued in connection with three kinds of plans maintained by employers for their employees:

- *Qualified 401(a) plans*, often just called qualified plans, including 401(k) defined contribution plans and defined benefit pension plans.[4]
- *Governmental 457(b) plans*, which are often offered to state and local government employees because, subject to a grandfather clause, most government employers cannot offer a 401(k) plan to employees.[5]
- *Section 403(b) plans*, which may only be maintained by employers exempt from income tax under Code section 501(c)(3) educational institutions, and certain religious organizations.

To regulate employer-based retirement plans, Congress has settled on a "carrot and stick" approach, and a well-administered annuity issued in connection with an employer-based plan should be cognizant of both. The "carrot" is very favorable tax deferral of contributions and earnings, but with a myriad of complex rules under the Code. The "stick" is the Employee Retirement Income Security Act of 1974, or ERISA, which imposes reporting, fiduciary and other requirements on most

plans,[6] and fairly significant penalties for noncompliance. Most of the obligations under ERISA fall on the employer or other fiduciary administering the plan, although some obligations are imposed on issuers of annuities sold to ERISA-governed plans, such as certain disclosure obligations. We will leave ERISA to the side for now and perhaps address it in a future "In the Beginning" article.

In general, annuities are used in the following three ways in connection with employer-based plans. First, annuities may be used to fund the plan. Second, annuities may be held as an investment asset in a trust that funds the retirement plan. For example, a plan might purchase and hold in trust a group annuity contract to provide a vehicle for offering and making life contingent annuity payments to participants. Finally, annuity contracts may be used to settle a plan's benefit obligation. For example, an annuity contract may be distributed to a plan participant in a 401(k) plan, with the participant as the named owner. Similarly, when a defined benefit pension plan terminates, it generally must purchase an annuity contract to provide the plan's promised benefits.

Section 403(b) plans, governmental 457(b) plans and qualified 401(a) plans receive very similar preferential tax treatment. In general, contributions to a qualified plan, section 403(b) plan or governmental 457(b) plan are excluded from an employee's gross income under the Code and most state income tax laws, so long as the contributions satisfy certain conditions and limits. The earnings credited to the employee under the plan accumulate on a tax-deferred basis. Both contributions and earnings become taxable only when distributed to the individual. Once distributed, these amounts are taxable as ordinary income unless rolled over to an IRA, a qualified plan, a section 403(b) plan or a governmental 457(b) plan. (More on rollovers below.) If the employer is a taxable entity, the employer may take an immediate deduction for contributions made to the plan, again subject to certain limits.

And this is the fundamental trade-off the Code makes between qualified and nonqualified arrangements. Unlike nonqualified annuities, the contributions made to annuities issued in connection with qualified arrangements may be made on a pre-tax basis (*i.e.*, the contributions are not included in the employee's income even though they are essentially compensation for work done for the employer). But in exchange, the Code imposes a variety of contribution and benefit limits. For example, a qualified 401(a) defined contribution plan is subject to an annual limit on an employee's elective salary deferral ($18,500 in 2018) and on total contributions by both the employer and employee ($55,000 in 2018). Plans are also subject to minimum coverage and nondiscrimination rules that are designed to ensure the plan covers an adequate cross-section of employees, not just the executives, and provides meaningful benefits to covered employees. Finally, the Code imposes restrictions on when a plan can distribute benefits to an employee—often restricting distributions while an employee is still working before attainment of age 59 ½.

Roth contributions. Qualified 401(a) plans, section 403(b) plans and governmental 457(b) plans may permit employees who make salary reduction contributions to designate some or all of those contributions as Roth contributions. Designated Roth contributions are currently included in an employee's gross income under the Code. The earnings credited to the employee and attributable to the designated Roth contributions accumulate on a tax-free basis. In contrast to pre-tax salary reduction contributions, however, a distribution of an amount attributable to designated Roth contributions, including earnings, is entirely excluded from the employee's gross income under the Code, although if a distribution is made before the individual reaches age 59 ½ and before the Roth account has been in existence for five years, the earnings on contributions will be taxable. Assuming an individual is in the same tax bracket at all times (and tax rates do not change), there is no effective difference between the tax treatment of a pre-tax contribution and a Roth contribution. However, the same Roth contribution produces a larger ultimate benefit in retirement than a pre-tax contribution of the same dollar amount because the employee effectively "pre-pays" the income tax.

Loans. Loans from an annuity contract issued in connection with a tax-favored retirement plan may be made on a nontaxable basis, provided that loans are permitted under the terms of the plan and the loans satisfy the requirements of Code section

72(p). Very generally, a loan is permissible if it does not exceed the lesser of (1) $50,000, reduced by outstanding loans, or (2) the greater of one-half the present value of the participant's vested accrued benefit or $10,000. In addition, to avoid treatment as a distribution, the loan must be repayable by its terms within five years,[7] and must be amortized in substantially level installments. If the loan fails to meet the foregoing requirements, for example because the employee fails to make required payments (violating the level amortization rule), the loan is "deemed" distributed, generating a taxable gross income for the employee of the amount of the outstanding loan.

Penalty tax. To encourage individuals to keep these savings preserved for retirement, an additional tax of 10 percent of the amount includible in gross income applies to early distributions from qualified 401(a) plans and section 403(b) plans.[8] There are numerous exceptions to the 10 percent penalty tax, including distributions made after the individual reaches age 59 ½ (55 if made after separation from service), death or disability.[9]

An exception to the 10 percent penalty that is commonly applied, and often misapplied, when annuities are involved is an exception for substantially equal periodic payments made after separation from service for the life or life expectancy of the individual, or the joint life or joint life expectancies of the individual and the designated beneficiary.[10] IRS guidance sets out three methods that can be used for calculating substantially equal periodic payments, including payments from deferred fixed and variable annuity contracts.[11]

Rollover. A rollover is a distribution that is paid into an IRA or another tax-favored plan to further delay income taxation. The terminology used for rollovers out of plans to IRAs (the most common rollover) is slightly different than when an individual moves from one IRA to another IRA. In the plan world, a "direct" rollover refers to a direct trustee-to-trustee transfer. An "indirect" rollover means a distribution paid to the individual that is then contributed to an IRA or other tax-favored plan. Such an indirect rollover generally must be made within 60 days of receipt of the distribution. By rolling over a distribution, an individual will avoid the 10 percent early distribution tax and defer income taxation until amounts are actually received in the future from the new plan or IRA.

Distributed annuity. Some of the most misunderstood sets of rules relate to an annuity distributed from a plan, particularly a qualified 401(a) plan; this is not the same as a rollover. If done correctly, an annuity can be distributed from a plan to the individual employee and the contract is tax-deferred (*i.e.*, tax is only assessed upon actual payments from the contract). This may be done as a distribution of an annuity contract (or certificate under a group annuity contract) from a trusteed plan issued in the name of the employee or as a transfer of title to an individual annuity contract. In order to preserve the tax-deferral, the distributed annuity must be nontransferable *after* ownership is transferred to the individual. If the contract is transferable after it has been distributed to the individual, the fair market value of the contract is taxable.[12]

Historically, annuity contracts have most often been distributed from qualified defined benefit plans in connection with the termination of the plan (what the industry calls "terminal funding" contracts). The distribution of the annuity contract effectively transfers the plan's liability to the insurer who is responsible for making payments. Annuity contracts are sometimes used in defined contribution retirement plans as an optional form of distribution. For example, a 401(k) plan might offer the individual the ability to receive his or her account balance in a single sum, in installment payments and in the form of a distributed annuity contract.

> To regulate employer- based retirement plans, Congress has settled on a "carrot and stick" approach, and a well- administered annuity issued in connection with an employer- based plan should be cognizant of both.

There are a few additional rules that apply to distributed annuity contracts, so when a contract held under a plan is distributed to the individual, it is important that the proper endorsement is added. For example, the distributed annuity contract must reflect the spousal consent requirements of Code section 401(a)(11) and, as a result, the insurer is responsible for obtaining spousal consent to certain distributions and any lump-sum distributions must be calculated to satisfy the rules in Code section 417.[13]

Taxation of after-tax contributions. Most contributions to qualified 401(a) plans and section 403(b) plans nowadays are made on a pre-tax or Roth basis. But plans can also accept after-tax contributions, which are important to distinguish from Roth contributions, even though both are contributed on an after-tax basis. Roth contributions (and earnings if certain requirements are met) are distributed tax-free, whereas with after-tax contributions, the earnings will be taxed when distributed. To be more specific: Distributions from annuities held as part of a tax-favored retirement plan or from annuities that themselves have been distributed from a tax-favored plan are generally taxed under the rules in Code section 72. Under Code section 72, distributions are taxed as ordinary income, except to the extent that the distributions represent what the Code calls the individual's "investment in the contract" but, in English, means amounts that have already been taxed. For qualified plans, that determination is generally made on a *pro rata* basis.

A simplified method for determining the nontaxable portion of amounts received as annuities from qualified 401(a) plans and section 403(b) annuities applies. Under this simplified method, the nontaxable portion of each annuity payment is calculated by dividing the investment in the contract by the number of monthly "anticipated payments." The number of anticipated payments is determined using Code-prescribed tables[14] based on the age of the primary annuitant (or combined ages for a joint and survivor annuity) on the annuity starting date. If annuity payments cease before the individual's entire nontaxable portion has been recovered because of the death of the individual, the amount of the unrecovered "investment in the contract" may be deducted by the individual in his or her last taxable year.

INDIVIDUAL RETIREMENT ACCOUNTS AND ANNUITIES

There are two basic IRA forms—an *individual retirement account* under Code section 408(a) and an *individual retirement annuity* under Code section 408(b). An individual retirement account is a trust or custodial account that holds investments for the exclusive benefit of an individual or the individual's beneficiaries. An individual retirement annuity is an annuity contract that is issued by an insurance company which meets certain requirements, including that the annuity must be nontransferable, must be nonforfeitable and must allow for flexible premiums. Generally, an annuity issued as an individual retirement annuity includes an IRA endorsement to satisfy these and other key rules.

IRAs were created by Congress in 1974 to allow individuals who did not have a retirement plan at work to save for retirement. The annual contribution limits for IRAs are much lower than the employer-based plans described above (generally $5,500 in 2018, with an additional amount for those 50 and older). Unlike plans, loans are not allowed from IRAs.

IRAs also come in two types based on their tax treatment—traditional IRAs and Roth IRAs. With a traditional IRA, contributions may be eligible for a deduction on an individual's return. Whether or not contributions to an IRA are partially or fully deductible depends on an individual's income, filing status, and whether the individual or his/her spouse participates in a retirement plan at work.[15] Whether contributions are deductible or not, earnings on contributions are not included in income until they are distributed from the IRA. Distributions generally are taxable except to the extent allocable to after-tax contributions (*i.e.*, contributions that the individual could not deduct) in which case, like with employer-based plans, the amount that is not taxable is determined under the rules in Code section 72. A full description of exactly how to determine the ratio of pre- and after-tax amounts in each partial distribution or annuity payment is a bit complicated to go into here, but a couple overall points: First, the ratio is determined differently depending on whether the distribution is in the form of an amount received as an annuity or not; as you might guess, it is not always obvious whether the distribution is "in the form of an amount received as an annuity." Second, all traditional individual retirement accounts and annuities are treated as one contract and all distributions during a taxable year are aggregated. If no amount under an IRA represents an after-tax contribution, the entire amount of a distribution is includible in gross income.

Roth IRAs generally work in reverse. No deduction is allowed for contributions to a Roth IRA. When amounts are distributed from the Roth IRA, however, there is no inclusion in income (even on earnings), as long as the individual is at least age 59 ½ and the Roth IRA has been open for at least five years. Thus, Roth IRAs operate, from a tax standpoint, very similar to Roth amounts held in a 401(k) plan.

An individual generally can decide to withdraw or annuitize an IRA at any time, but to encourage IRAs to be preserved for retirement, the 10 percent penalty tax described above also applies to IRAs for distributions before age 59 ½. As with employer-based plans, there are numerous exceptions from the 10 percent penalty, and even a few that apply only to IRAs, such as for first-time homebuyers or higher education expenses.[16]

REQUIRED MINIMUM DISTRIBUTION RULES

Both employer-based plans and IRAs are subject to what are known as required minimum distributions, or RMDs. The theory behind these rules is that since these tax-preferred arrangements are intended to fund retirement, they should not be allowed to accumulate tax-deferred income indefinitely and eventually must be distributed (and taxed). It is very important that any payments from a qualified annuity are made in compliance with the RMD rules.

The RMD rules require that distributions generally begin no later than April 1 following the calendar year in which the individual attains age 70 ½, or for employer-based plans, the year the individual retires if later. This date is known as the "required beginning date." Distributions then must be made over (1) the individual's life or the lives of the individual and his or her designated beneficiary; or (2) a period certain not extending beyond the individual's life expectancy or the joint life expectancies of the individual and his or her designated beneficiary. Distributions in the form of annuity payments must be made in periodic payments at intervals of no longer than one year. The pre-death RMD rules do not apply to Roth IRAs.

At a high level, the amount that must be distributed each year under the RMD rules is based on whether or not payments are being made in the form of an annuity. Before the contract has been annuitized, each year's required payment is based on the account rules, essentially dividing the value of the annuity as of the end of the prior year by an IRS-prescribed factor based on remaining life expectancy.[17]

Once payments begin in the form of an annuity, the RMD rules in Treas. Reg. section 1.401(a)(9)-6 focus not so much on the amount distributed each year but in ensuring that the annuity payments are made in a form that prevents "backloading" of the annuity payments to improperly defer taxation.[18] And this is perhaps the most important regulation for actuaries working with qualified annuities to understand because it limits the options for annuity payout and is rife with traps for the unwary.

After the individual dies, additional rules apply.[19] If the individual dies *after* the required distribution of his or her interest has begun (*i.e.*, on or after the required beginning date), the remaining portion of the account or annuity must continue to be distributed at least as rapidly as under the method of distribution being used before the individual's death. If distributions have not begun in the form of an annuity prior to the individual's death but the death occurred after the required beginning date, this "at-least-as-rapidly" requirement is satisfied by distributing the remaining interest over the longer of (1) the remaining life expectancy of the deceased individual, and (2) the remaining life expectancy of the designated beneficiary.

If the individual dies *before* the required beginning date, distribution of the individual's entire interest must be distributed by Dec. 31 of the calendar year containing the fifth anniversary of the individual's death; or over the life, or over a period certain not greater than the life expectancy, of the designated beneficiary commencing on or before Dec. 31 of the calendar year immediately following the calendar year in which the individual died.[20] The after-death RMD rules are more generous, however, if the designated beneficiary is the individual's surviving spouse.

CONCLUDING THOUGHTS

A "qualified" annuity is an annuity that has wrapped itself in the favorable treatment of a tax-preferred retirement arrangement. Understanding qualified annuities, and properly designing and administering them, really means understanding the complex rules that govern whatever arrangement under which the annuity is being held. Hopefully this high-level summary is a good start. ■

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ENDNOTES

1 John T. Adney, "How are Nonqualified Annuities Taxed?" *Taxing Times*, Vol. 12, Issue 1, March 2016.

2 Treas. Reg. § 1.451-1(a).

3 *Sproull v. Commissioner*, 16 TC 244 (1951), *aff'd per curiam*, 194 F.2d 541 (6th Cir, 1952); I.R.C. § 403(a).

4 A defined benefit plan is a plan where the promised benefit is a defined amount, usually an annuity based on a formula taking into account the employee's compensation and years of employment. For example, the plan might define the benefit as a single life annuity (with other optional forms available) starting at age 65 equal to 1 percent of the employee's average annual compensation times the employee's years of service for the employer. The plan must pay that benefit, regardless of the assets held in the plan or the investment results of the plan's trust, and the law requires the employer to set aside sufficient assets to fund the benefit. A defined contribution plan—and a 401(k) plan is the most common modern example—defines the benefit as simply the amount contributed by the employer and the employee, plus or minus earnings.

5 Governmental 457(b) plans differ from tax-exempt 457(b) plans. Tax-exempt 457(b) plans are a form of deferred compensation plan that may be maintained by nongovernmental tax-exempt entities (*e.g.*, charities and private universities). Tax-exempt 457(b) plans are generally not funded [although the employer may hold annuities as an informal funding method for a tax-exempt 457(b) plan]. Governmental 457(b) plans, in contrast, must be funded by a trust or by annuities, and thus operate very similarly to other types of tax-favored retirement plans.

6 There are certain plans that are exempt from ERISA, including plans of state and local governments and plans of churches.

7 There is an exception to the five-year payment rule for loans used to acquire a principal residence.

8 Distributions from a governmental 457(b) plan are not subject to the 10 percent additional tax, unless the distribution is attributable to an amount that was rolled over to the governmental 457(b) plan from a qualified 401(a) plan or section 403(b) plan.

9 A similar 10 percent penalty tax applies to distributions from nonqualified annuities before age 59 ½. *See* I.R.C. § 72(q).

10 One common trap for the unwary is a change in the method of determining the substantially equal payments, which can result in recapture of the penalty tax.

11 *See* Q&A-12 of Notice 89-25, as modified by Revenue Ruling 2002-62, which describes the required minimum distribution method, the fixed amortization method and the fixed annuity method.

12 Treas. Reg. §1.402(a)-1(a)(2).

13 Treas. Reg. §1.401(a)-20, Q&A-2.

14 I.R.C. § 72(d)(1)(B)(iii).

15 I.R.C. § 219. The rules for determining whether or not a contribution is deductible are summarized in IRS Publication 590-A, which is a good resource for learning the basics of IRA contributions.

16 I.R.C. § 72(t)(2)(E), (F).

17 Treas. Reg. § 1.401(a)(9)-5.

18 Treas. Reg. § 1.401(a)(9)-6.

19 Treas. Reg. § 1.401(a)(9)-2, Q&A-5; 1.401(a)(9)-5, Q&A-5.

20 Treas. Reg. § 1.401(a)(9)-3.