Article from

**Taxing Times**

March 2016
Volume 12
Issue 1

# In the Beginning … A Column Devoted to Tax Basics

## How Are Nonqualified Annuities Taxed?

By John T. Adney

The federal income tax law includes within its ambit "all income from whatever source derived,"[1] so it should be no surprise that payments insurers make from annuity contracts are subjected to it. What may be surprising, however, are the myriad rules in the Internal Revenue Code that govern how the federal government collects, and in some instances does not collect, that tax. This column endeavors to outline those rules as they apply to "nonqualified" annuity contracts issued by licensed insurance companies. A nonqualified annuity is one issued apart from an employer pension plan or individual retirement account (IRA) or other tax-qualified retirement arrangement. A description of the rules bearing on "qualified" annuities as well as arrangements known as "private annuities" (which do not involve insurers) will not be covered here since discussing the tax treatment of insurer-issued nonqualified annuities will involve enough of a journey for the reader.

Before launching into a description of the way federal law taxes (or refrains from taxing) the values of annuity contracts, it is necessary to understand what is meant by the term "annuity." The concept of an annuity is quite old, dating back to the Babylonian Empire of antiquity and possibly to the Chinese before then, and generally connotes an arrangement whereby one party, in return for a sum of money, agrees to make payments periodically to another party throughout the latter's life or for a specified term of years. Building on that principle, the modern insurer-issued annuity contract comes in a number of forms, most notably the deferred annuity and the immediate annuity. The deferred annuity, which may be purchased with a single consideration or multiple premium payments, contains the promise of periodic payments but defers for some time (and sometimes for quite a long time) the beginning of the payment stream. When the payment stream commences, the contract is said to be "annuitized." On the other hand, the immediate annuity, as its name suggests, is purchased with a single premium and begins making payments within one month to one year after its purchase. In either case, the periodic payments (aka annuity payments) may be made over the life or lives of a named annuitant or joint annuitants, for a specified term of years (known as a term certain), or for life with a minimum term or amount of payments.

Beyond these principal forms of annuities, many variations exist. For example, an annuity may be "fixed," meaning its values are guaranteed by the issuing insurer's general account, or "variable," meaning that its values can fluctuate with the market value of assets held in a separate account of the insurer. The modern deferred annuity usually offers cash surrender values, often subject to a surrender charge in a contract's early durations, and the modern immediate annuity or the deferred annuity that has been annuitized may or may not provide surrender or commuted values. Deferred annuities with cash values include the indexed annuity, which promises a return based on a market-based index if the contract continues to the end of a stated term, and the "modified" guaranteed annuity, which offers greater interest earnings over a stated term subject to a market value adjustment if the contract is surrendered before the term expires. On the other hand, in recent times an older form of deferred annuity has again become popular. Known as the deferred income annuity or longevity insurance, this form simply begins making payments at a stated age of the annuitant and offers no surrender value other than possibly a return of premium on premature death. A variant of this is sometimes called the contingent deferred annuity, which coordinates its promised payments with the depletion of a specified fund external to the contract. Somewhat similarly, the variable deferred annuity may come with guaranteed minimum withdrawal benefits (GMWBs), constituting a promise—without initially annuitizing the contract—to permit continued withdrawals for a specified term or over the life of the contract owner even after the contract's cash value has been reduced to zero, so long as the withdrawals have not exceeded a stated maximum. There is also a so-called temporary life annuity, with payments being made over the shorter of a specified term and the annuitant's life.

*Tax definition of "annuity."* The federal tax law endeavors to address all of these annuity forms, subject to its own definition of an annuity. The tax law's definition of an annuity is found partly in the Code, partly in the income tax regulations, and partly in case law (i.e., decisions by the courts). The regulations under section 72—the principal provision of the Code governing annuity taxation—largely define an annuity contract by drawing on insurance tradition. They provide that annuity contracts subject to the section 72 rules "include" those considered to be "annuity contracts in accordance with the customary practice of life insurance companies."[2] Thus, the treatment of a contract as an annuity under state law, which is the law governing insurer-issued annuities, would appear to be an important element in the tax definition. Further, according to the courts, to constitute an annuity contract under the tax law the contract must provide for periodic payments that will liquidate the premiums and any

earnings on those premiums.[3] This liquidation requirement, together with the reference to life insurers' customary practice, suggests that a deferred annuity contract should provide for a stated date on which annuity payments are to begin at some reasonable maximum age of the annuitant,[4] although there is little guidance and some debate on this point. The Code does, however, place a specific limit on the lifespan of an annuity contract, whether deferred or in payout mode, by requiring the liquidation of the contract when its owner (technically, the contract's "holder") or any one of multiple owners dies. Specifically, and importantly if the contract is to be treated as an annuity for tax purposes, section 72(s)[5] requires the contract to provide by its terms that:

- If any owner dies on or after the "annuity starting date," which is more or less when the payment stream begins, any remaining payments will be made at least as rapidly as they had been before death (i.e., the payments cannot be slowed down), and
- If any owner dies before then, the entire interest in the contract will be distributed within five years of death.

The statute allows two exceptions. First, an individual who is a designated death beneficiary may elect payments over his or her life (or a period not exceeding life expectancy) if the first payment is made within one year of death.[6] Second, if that beneficiary is the deceased owner's spouse, he or she may continue the contract as the new owner, assuming the contract so permits.

So, can the section 72(s) limitations be avoided by having an annuity held by a trust? After all, many deferred annuities are so held. Congress thought of that, specifying in section 72(s) that where an owner is not an individual, the statute's rules apply as if the "primary annuitant" were the owner, and if the annuitant is changed, the change is treated as the owner's death.[7] Fine, but what about simply gifting the annuity when the individual owner is on his or her deathbed? Congress thought of that, too. Pursuant to section 72(e)(4)(C), the complete gift of an annuity generally is treated as a surrender, subject to the tax consequences described below unless the donee is the transferor's spouse or former spouse.

*Inside buildup.* The good news for the annuity contract owner, if the contract meets the tax definition just described, is that any increments in the contract's cash surrender value generally are not taxable until they are distributed. This is true even though amounts of cash values allocated to or among investment options under a variable or indexed annuity are reallocated among such options. This treatment is often referred to as the "inside buildup" tax deferral. There is no provision in the Code that expressly provides this treatment, but the courts and the Internal Revenue Service (IRS) have agreed that this treatment exists, based on the structure of section 72 as well as the tax law's doctrine of constructive receipt. Congress has examined the treatment of the inside buildup from time to time and has sustained it as an important part of national retirement policy, although Congress also has taken steps to limit it, such as by enactment of the section 72(s) rules and also by denying this treatment to contracts that benefit corporations and other non-individuals. The latter restriction shows up in section 72(u), which taxes the income on such contracts to their owners as ordinary income in the year it arises, although a number of exceptions to this are available under the statute, most notably for immediate annuities and for a trust or other entity that owns the contract as an agent for a natural person. Since many annuities are trust-owned, this exception has been the object of much attention by the IRS and tax practitioners, who at times find its application less than crystal clear.[8] Still another limitation exists on a contract owner's ability to benefit from inside buildup tax deferral, applicable in the case of a variable contract. In such a case, the separate account investments funding the variable benefits must be "adequately diversified" pursuant to regulations under section 817(h), and the contract owner must not be viewed as controlling the underlying investments—the so-called investor control doctrine.[9]

*Taxing annuity benefits.* As just noted, when an annuity contract pays benefits, the payments become subject to federal income tax, either in whole or in part. Determining the extent of the taxation is the work of section 72, and what it requires depends on the nature of the payment:

- *Lump-sum surrenders and death benefits.* If a contract is fully surrendered for a lump-sum payment, the proceeds are taxable to the owner at ordinary income tax rates to the extent they exceed the investment in the contract. Also, the lump-sum payment of death benefits is taxed to the beneficiary in the same way; there is no annuity death benefit exclusion as there is for life insurance death benefits. In this context,

the phrase "investment in the contract" (sometimes called tax basis) means the premiums paid for the contract less any amounts previously received under it that were excludable from income. These rules appear in section 72(e).

- *Partial surrenders or withdrawals, including loans.* The amount of a partial surrender or withdrawal taken from an annuity contract before annuity payments begin, which the Code calls an "amount not received as an annuity," is taxable under section 72(e) at ordinary income tax rates to the extent the contract's cash value immediately before the withdrawal, unreduced by any surrender charges, exceeds the investment in the contract at that time (using the definition above). This creates an income-first or "LIFO" rule, which sounds simple enough but is complicated by some uncertainty on what a "cash value" is; the IRS and the Treasury Department are just now considering issuing guidance on this, even though the rule has been in the law for over three decades.[10] This rule applies to GMWBs to the extent they cannot qualify as annuity payments (see below). Also, if an amount is borrowed under or against an annuity contract, the borrowing is treated as a partial withdrawal, as is an assignment or pledge of the contract. Further, to prevent avoidance of the income-first rule through the purchase of a series of contracts, section 72(e)(12) "aggregates" all annuity contracts issued by the same insurer (or its affiliates) to the same owner during the same calendar year, i.e., they are treated as a single contract in measuring the income element of the withdrawal.[11]

- *Annuity payments.* The periodic payments made under an immediate annuity, or under a deferred annuity that has been annuitized, are referred to as "amounts received as an annuity." The treatment of these amounts under section 72(b) is a beneficial one, in that the investment in the contract is allowed to be recovered (untaxed) ratably with each payment, so that each payment is partly includible in and partly excludable from income. To qualify for this "exclusion ratio" treatment, the payments must pass three tests: (1) they must be made on or after the annuity starting date; (2) they must be made in periodic installments at regular intervals for more than one year; and (3) either the amount to be paid must be determinable when the payments begin or else the period over which the payments will be made must be determinable then but the amount of each payment may vary based on investment performance or "similar fluctuating criteria."[12] Despite the term "withdrawals" in their name, some GMWBs may qualify for exclusion ratio treatment, depending on their structure.

Annuity payments may be fixed or variable; the last of the three tests permits either (or a combination). In the case of fixed annuity payments, the excludable portion—i.e., the untaxed investment recovery—generally is the amount of the payment multiplied by the exclusion ratio, which in turn is computed as the investment in the contract on the annuity starting date, adjusted for any refund feature, divided by the expected return under the contract as of that date. See the sidebar for an illustration of this calculation that appears in the section 72 regulations. For variable annuity payments, this is done a little differently: the excludable portion of a payment equals the investment in the contract allocated to the variable account, again adjusted for any refund feature, divided by the number of payments expected. This results in a fixed excludable amount for each payment.[13] In neither case, however, will section 72(b) allow the taxpayer to recover more than the investment in the contract tax-free.[14]

> Every silver lining has a cloud, and the one that hovers over the beneficial treatment of the inside buildup of annuities is the section 72(q) penalty tax.

The regulations under section 72 spell out the rules for these calculations, including the three tests, in great detail.[15] However, the reader should be aware of the fact that the regulations, mostly dating from 1956, have not been updated to reflect many of the statutory changes made to section 72 in the 1980s and even as recently as 2010. In 2010, an amendment to section 72 clarified that a contract could be partially annuitized. To enable this, section 72(a)(2) treats the portion of the contract being annuitized as a separate contract, provides it with its own annuity starting date, and directs a pro rata allocation of the investment in the contract between the annuitized portion and the non-annuitized balance.

- *Penalty tax.* Every silver lining has a cloud, and the one that hovers over the beneficial treatment of the inside buildup of annuities is the section 72(q) penalty tax. To encourage the use of deferred annuities for retirement savings and discourage their potential use as short-term savings vehicles, Congress imposed a penalty tax equal to 10 percent of the income portion of annuity contract distributions that are considered premature. The exceptions to this additional tax are therefore important. Somewhat mirroring the rules for tax-qualified retirement plans, the penalty tax is not imposed on distributions when the taxpayer is over age 59-1/2 or disabled, payments from immediate annuities (as specially defined for tax purposes), death benefits, and substantially equal periodic payments made for life or over life expectancy, among others.

Example: Exclusion ratio for fixed annuity payments. Taxpayer A purchased an annuity contract providing for payments of $100 per month for a consideration of $12,650. Assuming that the expected return under this contract is $16,000, the exclusion ratio to be used by A is $12,650 ÷ 16,000, or 79.1 percent (79.06 rounded to the nearest tenth). If 12 such monthly payments are received by A during his taxable year, the total amount that A may exclude from gross income in such year is $949.20 ($1,200 × 79.1 percent). The balance of $250.80 ($1,200 less $949.20) is the amount to be included in gross income. If A instead received only five such payments during the year, A should exclude $395.50 (500 × 79.1 percent) of the total amounts received. [16]

- *Net investment income tax*. Distributions from annuity contracts do not escape the "net investment income tax" imposed by the 2010 health care legislation. The tax under section 1411 applies at a 3.8 percent rate on net investment income, subject to certain threshold amounts. Fortunately, only the portion of an annuity distribution that is taxable is considered net investment income, meaning in turn that the inside build-up is (again) not taxed unless and until amounts are distributed. The application of this tax to annuity contract payments was discussed at length in prior *Taxing Times* articles.[17]

*Exchanges, full and partial*. Another beneficial tax treatment accorded to annuities, among other insurance instruments, is that they may be exchanged tax-free for a new annuity contract or for a qualified long-term care insurance contract under section 1035. This treatment has been construed to extend to the exchange of one annuity contract for two, an exchange that consolidated one annuity into another existing one, the exchange of a fixed annuity for a variable one, and very importantly, the "partial exchange" of a contract, whereby a portion of the contract is transferred into a new or existing annuity. On the other hand, the IRS takes the position that a section 1035 exchange must be in-kind, not in cash, and any cash received in the course of the exchange is taxable as "boot," basically following an income-first rule. The IRS has published guidance on the conditions under which a partial exchange will be treated as tax-free. [18]

*Concluding thoughts*. The author's hope is that the reader of this column will gain some insight into the federal income tax treatment of nonqualified annuity contracts. The foregoing is far from a comprehensive treatise on annuity taxation. It generalizes many points and slides over some subtleties, and does not at all touch the taxation of annuities by the states (a few even impose a premium tax at annuitization). Annuity taxation is a complex subject with a rich history, but on reaching this point the reader will have made a start on the road to understanding it. ■

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## END NOTES

[1] I.R.C. § 61(a). Unless otherwise indicated, references to "section" are to sections of the Internal Revenue Code of 1986, as amended (the Code).

[2] Treas. Reg. § 1.72-2(a)(1). The regulations go on to say that section 72 can apply to annuities not issued by insurers.

[3] *See* Igleheart v. Comm'r, 10 T.C. 766 (1948), aff'd, 174 F.2d 605 (7th Cir. 1949).

[4] *See* Northern Trust Co. v. United States, 389 F.2d 731, 733 (7th Cir. 1968); GCM 38934 (July 9, 1982).

[5] Applicable to contracts issued after Jan. 18, 1985.

[6] A discussion of a recent IRS private letter ruling discussing this rule appears in this issue of *Taxing Times*. See Mark E. Griffin and Alison R. Peak, "IRS Applies Strict Reading of Section 72(s)," page 45.

[7] The section 72(s) rules do not apply to contracts used in qualified retirement plans or section 130 structured settlements. I.R.C. § 72(s)(5)(A)–(D).

[8] Current taxation of the inside buildup also applies, under the Code's "original issue discount" rules, in the case of a deferred annuity contract issued by an insurer (other than a tax-exempt insurer) not subject to tax by the United States with respect to the contract. Treas. Reg. § 1.1275-1(k). This rule typically affects foreign-issued deferred annuities.

[9] This doctrine encompasses an expansive and somewhat slippery subject. If the reader is so inclined, he or she may want to see the 92-page opinion of the U.S. Tax Court in a case called Webber v. Commissioner, 144 T.C. No. 17 (2015), which describes how not to arrange one's affairs to reduce taxation. An article on Webber also appears in this issue of *Taxing Times*. See Ann Cammack and Frederic J. Gelfon, "Investor Control: Will You Know it When You See it?" page 36.

[10] The income-first rule, enacted in 1982, does not apply to amounts allocable to investment before Aug. 14, 1982. See Revenue Ruling 85-159, 1985-2 C.B. 29.

[11] Applicable to contracts issued on or after Oct. 21, 1988.

[12] Treas. Reg. § 1.72-2(b)(2)–(3).

[13] *See* Treas. Reg. §§ 1.72-2(b)(3), 1.72-4(d)(3).

[14] A deduction is available under section 72(b) for any unrecovered investment in the contract when payments cease (such as by the annuitant's death).

[15] *See* the regulations under section 72 for these details, examples of the calculations, and the actuarial tables to be used. The regulations appear at Treas. Reg. § 1.72-1 through 18.

[16] Per Treas. Reg. § 1.72-4(a)(2).

[17] John T. Adney and Alison R. Peak, "Proposed Guidance on the New Net Investment Income Tax on 'Annuities'," *Taxing Times*, May 2013, Vol. 9, No. 2; John T. Adney and Alison R. Peak, "Tapping a New Revenue Source—Congress Expands the Medicare Tax Base to Include Income from 'Annuities'," *Taxing Times*, September 2010, Vol. 6, No. 3.

[18] *See* Rev. Proc. 2011-38, 2011-30 I.R.B. 66 (superseding and modifying Rev. Proc. 2008-24, 2008-13 I.R.B. 684).