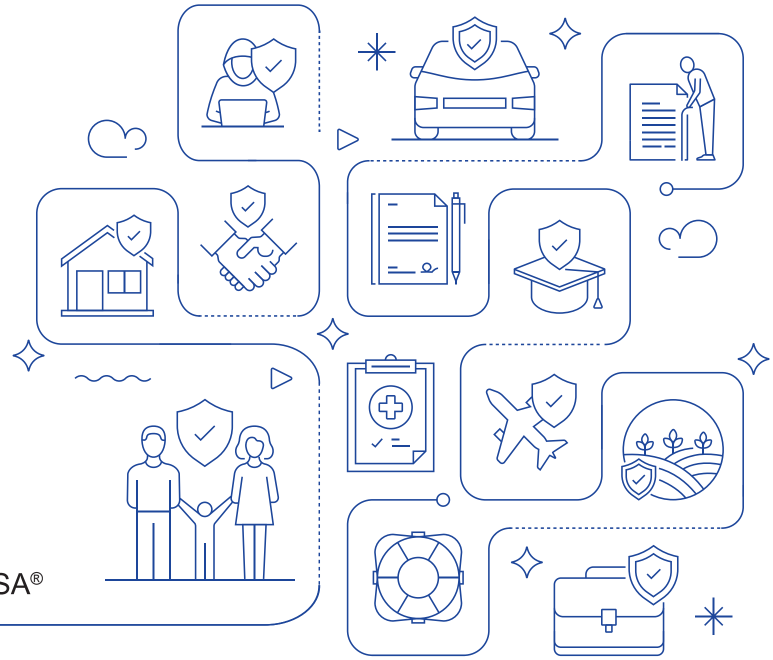

Answers to Annuities' Most Frequently Asked Questions

Authored By: Heather L. Schreiber, RICP® NSSA®

Annuities are available in various types and structures, such as non-qualified, qualified, variable, fixed, index, deferred, immediate, etc. As an advanced planning consultant of over 30 years, I have observed that financial professionals often find it challenging to navigate the tax complexities associated with annuities, particularly when pairing annuities with a tax-deferred source of funds like qualified monies or when non-natural owners such as trusts become part of the planning process. With that in mind, this month's edition will address the most common annuity-related questions I receive, hoping that the answers will clear up some gray areas for you, too!

It is important to remind clients to consult with their tax professionals to ensure that the discussed strategies suit their needs and align with their tax planning goals.

What is the difference between a deferred annuity and an immediate annuity?

A deferred annuity (DA) is a contract with an insurance company that promises to pay income at some future date in exchange for a lump sum or ongoing contribution(s). In contrast, an immediate annuity (IA) is purchased with a single lump sum in exchange for payments that begin within one year of purchase.[1]

Are deferred and immediate annuities taxed the same way?

No. Deferred annuities are generally taxed on a last-in, first-out basis (LIFO), meaning withdrawals first come from taxable earnings. Once earnings are depleted (on a non-qualified contract), the cost basis, or initial premiums paid to fund the contract, are returned tax-free. Any taxable portion of a withdrawal is taxed as ordinary income.[2] However, one point to note is that the cost basis established prior to August 14, 1982, referred to as pre-TEFRA basis, comes out on a first-in-first-out basis (FIFO). Policies that contain pre-TEFRA basis must separately account for this grandfathered basis to get the more favorable FIFO tax treatment on that portion of the basis.[3]

If the DA is qualified, meaning it's an IRA, for example, withdrawals are fully taxable unless there is basis in the policy from after-tax contributions (or non-deductible contributions). If an IRA also has after-tax contributions, any subsequent withdrawals will be taxed pro-rata; a percentage of each withdrawal will be a return of basis and pre-tax monies. When calculating taxable withdrawals, after-tax contributions in any IRA owned by the owner are combined.4

On the other hand, non-qualified immediate annuities are given preferential tax treatment, known as exclusion ratio treatment. The exclusion ratio refers to the portion of each immediate annuity payment not subject to taxes. Unlike a withdrawal from a deferred annuity that is taxed LIFO, each immediate annuity payment is calculated such that the percentage the cost basis bears to the payments is tax-free.[5]

Example: *Mary, age 60, purchases a single premium immediate annuity (SPIA) in January 2023 with $300,000. Mary will receive her first annual payment in January 2024, over ten years. $30,000 of each annual payment will be tax-free. The portion of the annuity payment over $30,000 will be taxable.*

If my client elects to turn on income on her non-qualified annuity, will the income payments be given the more favorable exclusion ratio treatment?

The answer is no, even if income is turned on within the first twelve months of purchase. Unlike an immediate annuity payment, which is irrevocable once elected, an income rider has flexibility. It does not fall under the definition of an immediate annuity to apply the exclusion ratio tax treatment. LIFO treatment will apply.

Are there exceptions to the 10% early withdrawal penalty on non-qualified annuities?

While the list of exceptions is far shorter than those that apply to qualified retirement accounts, like IRAs and 401(k)s, there are exceptions to the 10% early withdrawal tax; keep in mind that the 10% penalty on non-qualified annuities only applies to the taxable portion of the withdrawal taken prior to age 59 ½.

Exceptions to the early withdrawal tax on a non-qualified policy are:[6]

1. Attainment of age 59½.
2. The owner is disabled within IRC 72(m)(7).
3. The contract owner dies.
4. The gain on Pre-TEFRA contributions (prior to August 14, 1982).
5. Under an Immediate annuity (defined previously).
6. A series of substantially equal periodic payments based on the owner's life expectancy that continues for the longer of five years or attainment of age 59 ½. This is often referred to as "72(q) payments."

Note: The immediate annuity exception only applies to non-qualified policies in which the SPIA is purchased from an outside source of funds rather than a previously deferred annuity.

The immediate annuity exception never applies to a qualified annuity contract.

For a full list of exceptions to the 10% early withdrawal tax on qualified plans and IRAs, visit https://www.irs.gov/retirement-plans/plan-participant-employee/retirement-topics-exceptions-to-tax-on-early-distributions

Example: *Ronald, age 56, elects to 1035 exchange a non-qualified deferred annuity policy for a Single Premium Immediate Annuity (SPIA). Because the funds in the new SPIA were previously deferred, the 10% penalty would apply to the taxable portion of his payments until he reaches age 59 ½ unless Ronald set up a series of substantially equal payments based on his life expectancy or meets another exception mentioned above. The immediate annuity exception would not apply in this scenario.*

Conversely, had Ronald funded the SPIA with "new money," meaning money that was not previously in a non-qualified annuity, the taxable portion of his income payments would not be subject to the 10% early withdrawal penalty, regardless of whether he chose a period certain or lifetime payout structure.

Can a non-natural owner own a non-qualified annuity?

The short answer is yes, but non-natural ownership may change the tax treatment of subsequent withdrawals. Generally, a policy owned by a non-natural person ceases to be treated as an annuity contract; therefore, the income on the contract, or gain on the policy, must be taxed in the year it is earned rather than being tax-deferred until withdrawn.[7] Examples may include a corporate or charity-owned policy.

So, for example, a corporate-owned policy will be taxed annually on any earnings. For this reason, some carriers may not permit such policies. Please consult your marketer to determine each carrier's policies and requirements for non-natural ownership.

Agent for a Natural Person Exception

There is an exception to the current taxation of earnings on a non-natural owner policy. If a trust or other entity owns the policy as an "agent for a natural person," tax deferral is permitted until a withdrawal occurs. This exception applies to a revocable or irrevocable trust owned for the benefit of natural persons, an estate or trust-owned policy on behalf of a deceased person, an immediate annuity, or a qualified trust in the case of a retirement plan.[8]

Besides the standard application, a non-natural ownership form must be submitted with the application for all non-natural owner policies.

Is there a tax implication if my client wants to change the owner of their non-qualified annuity?

It is possible to change the ownership of a policy, but there are some limitations associated with it. You can do this by adding or removing a joint owner, transferring the policy to another entity or owner, or by assigning the policy to someone else. However, in all three cases, the earnings on the policy at the time of transfer will be taxable to the original owner(s). If the existing policy owner is under 59 ½, they may also have to pay a 10% penalty for early withdrawal on the taxable portion.[9] Additionally, it is important to note that the change of ownership is considered a gift, which may require payment of gift taxes. The exceptions to the rules outlined above are:

1. A transfer of ownership from one spouse to another or the addition or deletion of a spouse
2. A transfer of ownership pursuant to a divorce
3. A transfer of ownership between the owner and his/her revocable (grantor) trust.[10]

Example: *Switching ownership between spouses*

Non-qualified annuity Policy A is co-owned by husband and wife, Robert and Barbara. The couple would like to 1035 exchange Policy A for Policy B at a new carrier. Robert is 87 years old, and their chosen carrier will not accept an issue age above 85. To circumvent this challenge, Robert and Barbara request to change the ownership of Policy A to Barbara only, who is 80, and then proceed with the 1035 exchange to Policy B. This ownership change from jointly owned to owned by Barbara will not trigger a taxable event.

Example: *Switching ownership from an individual to his/her grantor trust*

Susan has recently established a revocable living trust with the assistance of her attorney. Per her attorney's advice, Susan wishes to transfer her non-qualified annuity to her trust. To achieve this, she must fill out a change of ownership form from her annuity carrier, with no tax liability on the gain. However, the policy must be distributed within five years of her death. This can result in accelerated taxes, an unintended consequence of re-titling a policy to a revocable trust. The same trust should be named as the beneficiary of the policy, and the five-year rule applies upon the grantor's death.

Practical Tip: To avoid the legal process of probate, individuals can name a designated beneficiary on their annuities and life insurance policies. This way, the proceeds will be paid directly to the named beneficiaries. It is recommended to advise clients considering transferring ownership to a trust to consult their legal counsel to understand the potential tax implications fully.

Qualified Annuities and Required Minimum Distributions (RMDs)

My clients are so confused. I thought RMDs began at 72, and now I hear it is 73 or maybe later.

Based on the number of calls I receive daily on this topic, you are not alone. The longstanding benchmark age of 70 ½ was replaced, albeit only briefly, by age 72 by SECURE 1.0 in 2019. Once the Son of SECURE rolled around, almost 3 years to the day later, in 2022, the rules changed again, and here is where we landed. Individuals born between 1951 and 1959 must begin RMDs in the year they reach age 73; those born in 1960 or later must begin RMDs in the year they reach 75.[11] Those born prior to 1951 would have already begun RMDs at either the 72 or 70 ½ mark. The first year RMD can be delayed to as late as April 1st of the calendar year immediately following the year the IRA owner turns 73, for example, but, in so doing, the owner has to double up the second year, so it's a double RMD year which means double the taxes due on RMDs.

"My client's mother, who was 89 years old, left her IRA annuity to my client upon her death in 2021. The mother had satisfied her final Required Minimum Distribution (RMD) in 2021. However, my client did not take an RMD last year, as she believed that the money needed to be completely withdrawn from the Inherited IRA by the end of the tenth year. But now, she has come to know that there might be a different requirement. I also thought she had until the end of year ten to withdraw the money. What should I tell her?"

There has been a lot of confusion surrounding the implementation of the ten-year rule for designated beneficiaries who do not qualify as eligible designated beneficiaries. This confusion stems from conflicting language within SECURE 1.0, subsequent language in the proposed final regulations, and examples provided in IRS Publication 590-B. The original SECURE did not distinguish the decedent's age on how the 10-year rule applied. The only distribution required was by December 31st of the tenth year following the decedent's death.

However, subsequent guidance indicated that if the decedent was already subject to Required Minimum Distributions (RMDs) at the time of death, the designated beneficiary must continue taking RMDs in years 1-9 of the 10-year distribution period, with the remaining balance distributed by December 31st of the tenth year.

To address the confusion and help unsuspecting beneficiaries unaware of an annual RMD requirement and practitioners seeking clarification of conflicting guidance, the IRS issued two Notices waiving penalties for missed RMDs through 2023 for those inheriting IRAs in 2020, 2021, and 2022. These notices are IRS Notice 2022-53 and IRS Notice 2023-54. The IRS is expected to issue clarification in 2024.

It's worth noting that designated beneficiaries of decedents who died before their required beginning date and beneficiaries of Roth IRAs are unaffected by the confusion. They are not required to take withdrawals during the 10-year period other than by December 31st of the tenth year.

My client's mother recently passed away and named him as the beneficiary of her non-qualified annuity. He wants to transfer the inherited funds to another carrier. Can he perform a 1035 exchange on an inherited non-qualified annuity?

This situation has been uncertain for a long time, but more and more carriers are now willing to process a post-death 1035 exchange for a non-spousal beneficiary. Private Letter Ruling 201330016 is the basis for the IRS's position, which allows a non-spousal beneficiary to exchange one deferred annuity for another.

However, a private letter ruling applies only to the taxpayer requesting the ruling and cannot be considered a general principle. It indicates how the IRS would view a similar situation.

If you're dealing with a scenario like this, you need to check if the existing non-qualified carrier allows a 1035 exchange to an inherited annuity with another carrier. If yes, the next step is to find a carrier that accepts an inherited annuity. You can start by reviewing the existing carrier's death claim form, and your marketer can help you navigate the available options.

It's important to note that the non-spousal beneficiary should not receive the funds with the intent of rolling over within 60 days as this is not permitted in either the non-qualified or qualified arena, and it would make the distribution taxable.

When in doubt, reach out.

The tax rules governing annuities can be quite complex, and therefore, it's always advisable to seek help when in doubt. If you are uncertain about the consequences of a particular scenario that your client is facing, it's best to contact your marketer. Additionally, you should always encourage your clients to seek advice from a reputable tax professional before taking any course of action.

Sources:

[1]IRC 72(u)(4)

[2]IRC72(e)(2)(B)

[3]IRC72(e)(5)(B)

[4]https://www.irs.gov/pub/irs-pdf/p590b.pdf Distributions Fully or Partly Taxable

[5]IRC72(b)(1)

[6]IRC 72(q)

[7]IRC72(u)(1)(B)

[8]IRC 72(u)(3)

[9]IRC72(e)(C)(i)

[10]IRC72(e)(C)(ii)

[11]SECURE 2.0 Section 107