PART VI: ANNUITIES

In General

437. What is an annuity contract?

An annuity contract is a financial instrument where a premium is paid to a company (or in some cases to an individual) in return for a promise to pay a certain amount for either a specific period of time or over a person's lifetime. There are different variations of this basic form. An immediate annuity contract is one in which regular annuity payments will commence within one year. A deferred annuity contract is one in which the annuity start date (i.e., the date when regular annuity income payments begin) is deferred until the contract's owner elects to start payments; payments can be deferred for many years, and in today's world many annuity owners simply maintain the contract in deferred status. Nonqualified annuities are annuities that are not held within a "qualified" retirement plan or an IRA (Q 3758).

The term "annuity" includes all periodic payments resulting from the systematic liquidation of a principal sum and refers not only to payments for a life or lives, but also to installment payments that do not involve life contingency, such as payments under a "fixed period" or a "fixed amount" settlement option.[1]

438. What general rules govern the income taxation of payments received under annuity contracts?

The rules in IRC Section 72 govern the income taxation of all amounts received under nonqualified annuity contracts. IRC Section 72 also covers the tax treatment of policy dividends and forms of premium returns. Qualified annuity contracts are governed by the tax rules of the retirement account in which they are held.

All "amounts received" under an annuity contract are either "amounts received as an annuity" or "amounts not received as an annuity."

"Amounts received as an annuity" (annuity payments) are taxed under the annuity rules in IRC Section 72. These rules determine what portion of each payment is excludable from gross income as a return of the purchaser's investment and what portion is taxed as interest earned on the investment. They apply to life income and other types of installment payments received under both immediate annuity contracts, and deferred annuity contracts that have been annuitized (Q 450 to Q 470).[2]

Payments consisting of interest only are not annuity payments and thus are not taxed as "amounts received as an annuity." Periodic payments on a principal amount that will be returned intact on demand are interest payments.[3] Such payments, and all amounts taxable under IRC Section 72 other than regular annuity payments, are classed as "amounts not received as an annuity." These include amounts actually received as policy dividends, lump sum cash settlements of

1. Treas. Regs. §1.72-1(b), §1.72-2(b).
2. IRC Sec. 72(a); Treas. Reg. §1.72-1.
3. Rev. Rul. 75-255, 1975-2 CB 22.

cash surrender values, cash withdrawals and amounts received on partial surrender, death benefits under annuity contracts, a guaranteed refund under a refund life annuity settlement,[1] and policy loans, as well as amounts received by imputation (annuity cash value pledged as collateral for a loan). "Amounts not received as an annuity" are taxable under general rules discussed in Q 441 and Q 446. The taxation of distributions from life insurance policies is discussed in Q 10 and Q 13.

Except in the case of certain annuity contracts held by non-natural persons (Q 439), income credited on a deferred annuity contract is not currently includable in a taxpayer's income. There is no specific IRC section granting this "tax deferral." Instead, it is granted by implication. The increase in cash value of an annuity contract, other than by application of dividends, is neither an "amount received as an annuity" nor an "amount not received as an annuity." As a result, an increase in cash value is not a distribution and is not includable in the taxpayer's income, except where the IRC specifically provides otherwise (Q 439).

IRC Section 72 places a penalty on "premature distributions" (Q 446).

Contracts issued after January 18, 1985 have post-death distribution requirements (Q 517). These post-death distribution requirements also apply to contributions made after January 18, 1985, to contracts that were issued before that date. Contracts issued before January 18, 1985, with contributions that were made before that date are not subject to post-death distribution requirements.

The income tax treatment of life insurance death proceeds is governed by IRC Section 101, not by IRC Section 72. Consequently, the annuity rules in IRC Section 72 do not apply to life income or other installment payments under optional settlements of life insurance death proceeds. However, the rules for taxing such payments are similar to the IRC Section 72 annuity rules (Q 62 to Q 74). On the other hand, as noted earlier, death proceeds under an annuity contract (i.e., from some form of guaranteed death benefit) are taxed as amounts not received as an annuity (Q 441, Q 446).

Employee annuities, under both qualified and nonqualified plans, and periodic payments from qualified pension and profit sharing trusts are taxable under IRC Section 72, but because a number of special rules apply to these payments, they are treated separately (Q 3523 to Q 3531, Q 3841 to Q 3869, Q 3958).

Annuity with long-term care rider. Under the Pension Protection Act of 2006, qualified long term care insurance can be provided as a rider to an annuity contract, beginning after December 31, 2009.

439. How are annuity contracts taxed that are held by corporations and other non-natural persons?

Except as noted below, to the extent that contributions are made after February 28, 1986 to a deferred annuity contract held by a corporation or another entity that is not a natural person, the contract is not treated for tax purposes as an annuity contract.

1. Treas. Reg. §1.72-11.

When an annuity contract is no longer treated as an annuity for tax purposes, income on the contract is treated as ordinary income received or accrued by the owner during the taxable year.[1] "Income on the contract" is the excess of (1) the sum of the net surrender value of the contract at the end of the taxable year and any amounts distributed under the contract during the taxable year and any prior taxable year over (2) the sum of the net premiums (the amount of premiums paid under the contract reduced by any policyholder dividends) under the contract for the taxable year and prior taxable years and any amounts includable in gross income for prior taxable years under this requirement.[2]

This rule does not apply to any annuity contract that is:

(1) acquired by the estate of a decedent by reason of the death of the decedent;

(2) held under a qualified pension, profit sharing, or stock bonus plan, as an IRC Section 403(b) tax sheltered annuity, or under an individual retirement plan;

(3) purchased by an employer upon the termination of a qualified pension, profit sharing, or stock bonus plan or tax sheltered annuity program and held by the employer until all amounts under the contract are distributed to the employee for whom the contract was purchased or to the employee's beneficiary;

(4) an immediate annuity (i.e., an annuity that is purchased with a single premium or annuity consideration, the annuity starting date of which is no later than one year from the date of purchase, and that provides for a series of substantially equal periodic payments to be made no less frequently than annually during the annuity period); or

(5) a qualified funding asset (as defined in IRC Section 130(d) but without regard to whether there is a qualified assignment).[3] A qualified funding asset is any annuity contract issued by a licensed insurance company that is purchased and held to fund periodic payments for damages, by suit or agreement, on account of personal physical injury or sickness.[4]

These requirements apply "to contributions to annuity contracts after February 28, 1986."[5] It is clear that if all contributions to the contract are made after February 28, 1986, the requirements apply to the contract. It seems clear enough that if no contributions are made after February 28, 1986 to an annuity contract, such contract held by a non-natural person is treated for tax purposes as an annuity contract and is taxed under the annuity rules (Q 437). If contributions have been made both before March 1, 1986, and after February 28, 1986, to contracts held by non-natural persons, however, it is not clear whether the income on the contract is allocated to different portions of the contract and whether the portion of the contract allocable to contributions before

1. IRC Sec. 72(u).
2. IRC Sec. 72(u)(2).
3. IRC Sec. 72(u)(3).
4. IRC Sec. 130.
5. TRA '86 Sec. 1135(b).

March 1, 1986, may continue to be treated as an annuity contract for income tax purposes. The IRC makes no specific provision for separate treatment of contributions to the same contract made before March 1, 1986, and those made after February 28, 1986.

For annuity contracts held by a non-natural person as agent for a natural person, see Q 440.

440. If an annuity is held by a trust or other entity as agent for a natural person, does the general rule that annuities held by non-natural persons are not taxed as annuities apply?

An annuity contract held by a trust or other entity as agent for a natural person is considered held by a natural person.[1] If a non-natural person is the nominal owner of an annuity contract but the beneficial owner is a natural person, the annuity contract will be treated as though held by a natural person.[2] Also, an annuity owned by a grantor trust will be considered to be owned by the grantor of the trust.

In a letter ruling, the IRS decided that a trust was considered to hold an annuity contract as an agent for a natural person where the trust owned an annuity contract which was to be distributed, prior to its annuity starting date, to the trust's beneficiary, a natural person.[3]

In another ruling, the IRS considered an irrevocable trust whose trustee purchased three single premium deferred annuities, naming the trust as owner and beneficiary of the contracts and a different trust beneficiary as the annuitant of each contract. The terms of the trust provided that the trustee would terminate the trust and distribute an annuity to each trust beneficiary after a certain period of time. The IRS held that the non-natural person rule was not applicable.[4]

The IRS concluded that the non-natural person rule does not apply to a trust that had invested trust assets in a single premium deferred variable annuity where the same individual was the sole annuitant under the contract and the sole life beneficiary of the trust.[5]

Where a trustee's duties were limited to purchasing an annuity as directed by an individual and holding legal title to the annuity for that individual's sole benefit and the trustee was not able to exercise any rights under the annuity contract unless directed to do so by the individual, the IRS concluded that the trustee was acting as an agent for a natural person.[6]

Further, where the trustee of an irrevocable trust purchased an annuity and had the power to select an annuity settlement option or terminate the annuity contract, the annuity was still considered to be owned by a natural person.[7]

1. IRC Sec. 72(u)(1).
2. H.R. Conf. Rep. No. 99-841 (TRA '86) *reprinted in* 1986-3 CB Vol. 4 401.
3. Let. Rul. 9204014.
4. Let. Rul. 199905015.
5. Let. Rul. 9752035.
6. Let. Rul. 9639057.
7. Let. Rul. 199933033.

A charitable remainder unitrust, however, was not considered to hold an annuity contract as an agent for a natural person and, thus, was required to include income on any annuity contracts in ordinary income each year.[1]

Although it is not entirely clear that all permissible beneficiaries of a trust named as owner of a deferred annuity must be natural persons, it is significant that, as of June 2010, all private letter rulings addressing whether a trust named as owner of a deferred annuity was acting as "the agent of a natural person" have specified that all beneficiaries were, in fact, natural persons.[2]

If all beneficiaries of a trust owning a deferred annuity must be natural persons, must the term "beneficiary" be taken literally? In the case of a "special needs" trust (such as an OBRA "D(4)(A)" trust), it is not clear whether the position of creditor occupied by the state Medicaid agency (to the extent of any Medicaid payments made to the trust beneficiary) will constitute the interest of a "beneficiary," where the state Medicare statute does not specify that the state's interest is that of a "beneficiary."

Amounts Not Received as an Annuity

In General

441. What basic tax rules govern dividends, cash withdrawals, and other amounts received under annuity contracts before the annuity starting date?

Dividends, Cash Withdrawals, Loans, Partial Surrender

Policy dividends (unless retained by the insurer as premiums or other consideration), cash withdrawals, amounts received as loans and the value of any part of an annuity contract pledged or assigned, and amounts received on partial surrender under annuity contracts entered into after August 13, 1982, are taxable as income to the extent that the cash value of the contract immediately before the payment exceeds the investment in the contract (i.e., to the extent there is gain in the contract).[3] To the extent the amount received is greater than the gain, the excess is treated as a tax-free return of investment. In effect, this ordering treatment results in distributions being treated as interest or gains first and only second as recovery of cost. (In addition, taxable amounts may be subject to a 10 percent penalty tax unless paid after age 59½ or disability (Q 446)).

For the purpose of determining the taxable portion of a partial surrender, cash surrender value is determined without regard to any surrender charge.[4] This is not the case with regard to total surrenders (Q 512). Investment in the contract is, under the general rule, reduced by previously received excludable amounts. However, if annuity loans are involved, investment in

1. Let. Rul. 9009047.
2. Let Ruls. 20049011, 20049013, 20049014, 20049015, 20049016, 200018046.
3. IRC Sec. 72(e).
4. IRC Sec. 72(e)(3).

the contract is increased by loans treated as distributions to the extent the amount is includable in income, although not reduced to the extent it is excludable.[1]

Policy dividends, cash withdrawals, and amounts received on partial surrender under annuity contracts entered into before August 14, 1982 (and allocable to investment in the contract made before August 14, 1982) are taxed under the "cost recovery rule." Under the cost recovery rule, the taxpayer may receive all such amounts tax-free until the taxpayer has received tax-free amounts equal to his or her pre-August 14, 1982 investment in the contract; the amounts are taxable only after such basis has been fully recovered.[2]

Amounts received that are allocable to an investment made after August 13, 1982, in an annuity contract entered into before August 14, 1982, are treated as received under a contract entered into after August 13, 1982, and are subject to the "interest first" rule.[3] If an annuity contract has income allocable to earnings on pre-August 14, 1982 and post-August 13, 1982 investments, the amount received is allocable first to investments in the contract made prior to August 14, 1982, then to income accumulated with respect to such investments (under the "cost recovery" rule, see next paragraph), then to income accumulated with respect to investments made after August 13, 1982, and finally to contributions made after August 13, 1982, under the "interest-first" rule.[4]

Where, as part of the purchase of a variable annuity, a taxpayer entered into an investment advisory agreement that stated that the company issuing the annuity would be solely liable for payment of a fee to an investment adviser who would manage the taxpayer's funds in the variable accounts, the fee was considered to be an amount not received as an annuity and, thus, includable in the taxpayer's income to the extent allocable to the income on the contract.[5]

For tax years after 2009, a charge against the cash surrender value of an annuity contract or life insurance contract for a premium payment of a qualified long-term care contract (Q 424) that is a rider to the annuity or life contract will not be included in the gross income of the taxpayer. The investment in the contract for the annuity or life contract will be reduced by the amount of the charge against the cash surrender value.[6]

Special rules applicable to amounts received under pension, profit sharing, or stock bonus plans, under annuities purchased by any such plan, or under IRC Section 403(b) tax sheltered annuities are discussed in Q 539 to Q 3864, and Q 3958. The rules applicable to loans under qualified plans and under tax sheltered annuity (IRC Section 403(b)) contracts are discussed in Q 3848 and Q 3937, respectively.

1. IRC Sec. 72(e)(4).
2. IRC Sec. 72(e)(5).
3. IRC Sec. 72(e)(5).
4. Rev. Rul. 85-159, 1985-2 CB 29.
5. Let. Rul. 9342053.
6. IRC Sec. 72(e)(11).

Other Amounts

The purpose behind the "interest first" rule applicable to investment in contracts after August 13, 1982 is to limit the tax advantages of deferred annuity contracts to long-term investment goals, such as income security, and to prevent the use of tax deferred inside build-up as a method of sheltering income on freely withdrawable short term investments.

Consistent with this purpose, other amounts that are neither interest payments nor annuities received under annuity contracts, regardless of when entered into, are not treated first as interest distributions, but are taxed under the cost recovery rule. These amounts include lump sum settlements on complete surrender (Q 512), annuity contract death benefits (Q 516), and amounts received in full discharge of the obligation under the contract that are in the nature of a refund of consideration, such as a guaranteed refund under a refund life annuity settlement (Q 469).[1]

Effect of Tax-Free Exchange

To give effect to the grandfathering of pre-August 14, 1982 annuities, a replacement contract obtained in a tax–free exchange of annuity contracts (Q 495) succeeds to the status of the surrendered contract for purposes of determining when amounts are to be considered invested and for computing the taxability of any withdrawals.[2] Investment in the replacement contract 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 contract.

442. Is an individual who transfers an annuity contract without adequate consideration treated as receiving amounts "as an annuity"?

An individual who transfers any annuity contract issued after April 22, 1987 for less than full and adequate consideration will be treated as having received an "amount not received as an annuity" unless the transfer is between spouses or incident to a divorce under the IRC Section 1041 non-recognition rule (Q 101). The amount the transferor will be deemed to have received is the excess of the cash surrender value of the contract at the time of the transfer over the investment in the contract at that time. The transferee's investment in the contract will be increased by the amount, if any, included in income by the transferor (Q 505).[3]

Planning Point: This provision effectively prevents annuity owners from transferring their gain to another individual through gifting the annuity contract, because the gains embedded in the contract become taxable to the transferor at the time of transfer.

443. Are multiple annuity contracts aggregated for purposes of determining the amount of a distribution that is includable in income?

All annuity contracts entered into after October 21, 1988 that are issued by the same company to the same policyholder during the same calendar year will be treated as one aggregated

1. IRC Sec. 72(e)(5).
2. Rev. Rul. 85-159, 1985-2 CB 29.
3. IRC Sec. 72(e)(4)(C).

annuity contract for purposes of determining the amount of any distribution that is includable in income under the rules explained in Q 441 and Q 442.[1] An annuity that is received as part of an IRC Section 1035 exchange that was undertaken as part of a troubled insurer's rehabilitation process under Revenue Ruling 92-43 (Q 495) is considered to have been entered into for purposes of the multiple contract rule on the date that the new contract is issued. The newly-received contract is not "grandfathered" back to the issue date of the original annuity for this purpose.[2]

This aggregation rule does not apply to distributions received under qualified pension or profit sharing plans, from an IRC Section 403(b) contract, or from an IRA.[3] The Conference Report on OBRA '89 also states the aggregation rule does not apply to immediate annuities.

If the contract is owned by a corporation or other non-natural person, see also Q 439.

For amounts received under life insurance or endowment contracts, see Q 10. For distributions received under life insurance policies that are classified as modified endowment contracts, see Q 13.

444. What is a guaranteed lifetime withdrawal benefit rider?

A guaranteed lifetime withdrawal benefit rider (GLWB) guarantees that the taxpayer will be able to withdraw a certain percentage of the value of the benefit base of the taxpayer's annuity, which has been growing by a guaranteed amount over the course of the deferral period (the guarantee is commonly somewhere between 4 and 8 percent). Taxpayers looking for larger payouts later in life should be advised that the longer the base account is allowed to grow, the larger the withdrawals will be in the future. Further, it is important that the taxpayer understand that he or she must stay within the limits of the guaranteed withdrawals; some contracts provide for termination of the feature if the taxpayer takes an excess withdrawal.

One common ground between these types of riders and a lifetime income benefit rider (LIBRs, see Q 445) lies in the fact that the benefit base itself is not available for cash withdrawals. This "account" has no real current cash value to the taxpayer—meaning that, unlike the accumulation value of the account, the taxpayer cannot access this value through surrendering the contract prior to the end of the deferral period.

445. What is a lifetime income benefit rider (LIBR)?

A lifetime income benefit rider (LIBR), while similar to a guaranteed lifetime withdrawal benefit rider (GLWB, see Q 444)), is a rider pursuant to which the annuity carrier agrees to pay income over the taxpayer's lifetime in the form of an annuity. The income stream that results once the taxpayer annuitizes the contract is also drawn from the annuity's benefit base, but the carrier uses the taxpayer's life expectancy to determine the value of the guaranteed income payments. Taxpayers seeking out steady, level annuity payouts that are guaranteed regardless of how long they live are often attracted to this type of feature.

1. IRC Sec. 72(e)(12).
2. Let. Rul. 9442030.
3. IRC Sec. 72(e)(12)(A).

One common ground between a LIBR and GLWB is the fact that the benefit base itself is not available for cash withdrawals. The benefit base is an "account" that has no real current cash value to the taxpayer—meaning that, unlike the accumulation value of the account, the taxpayer cannot access this value through surrendering the contract prior to the end of the deferral period.

446. What penalties apply to "premature" distributions under annuity contracts?

To discourage the use of annuity contracts as short term tax sheltered investments, a 10 percent tax is imposed on certain "premature" payments under annuity contracts.[1] The penalty tax potentially applies to any payment received to the extent the payment is includable in income. Exceptions to the penalty tax include:

(1) any payment made on or after the date on which the taxpayer becomes age 59½;

(2) any payment made on or after the death of the holder (or the primary annuitant in the case where the holder is a non-natural person);

(3) any payment attributable to the taxpayer's becoming disabled;

(4) any payment made under an immediate annuity contract;[2]

(5) any payment that is part of a series of substantially equal periodic payments (SEPPs) made (not less frequently than annually) for the life or life expectancy of the taxpayer or the joint lives or joint life expectancies of the taxpayer and his or her designated beneficiary (see Q 447);

(6) any payment made from a qualified pension, profit sharing, or stock bonus plan, under a contract purchased by such a plan, under an IRC Section 403(b) tax sheltered annuity, from an individual retirement account or annuity, or from a contract provided to life insurance company employees under certain retirement plans (but such payments are subject to similar premature distribution limitations and penalties; see Q 3629, IRA; Q 3860, pension, profit sharing, stock bonus; Q 3948, tax sheltered annuity);

(7) any payment allocable to investment in the contract before August 14, 1982, including earnings on a pre-August 14, 1982 investment;[3]

(8) any payment made from an annuity purchased by an employer upon the termination of a qualified plan and held by the employer until the employee's separation from service; or

1. IRC Sec. 72(q).
2. An immediate annuity contract is one that is purchased with a single premium or annuity consideration, the annuity starting date of which is no later than one year from the date of purchase, and that provides for a series of substantially equal periodic payments to be made no less frequently than annually during the annuity period. IRC Sec. 72(u)(4); see Let. Ruls. 200818018 (variable annuity), 200036021.
3. Rev. Rul. 85-159, 1985-2 CB 29. See also H.R. Conf. Rep. 97-760 (TEFRA '82) *reprinted in* 1982-2 CB 685-686.

(9) any payment under a qualified funding asset (i.e., any annuity contract issued by a licensed insurance company that is purchased as a result of a liability to make periodic payments for damages, by suit or agreement, on account of personal physical injury or sickness).

Planning Point: *SEPPs*. From a practical standpoint, it would appear imprudent for an individual younger than age forty five to attempt to qualify for the exception for substantially equal periodic payments. A period longer than fifteen years may afford too much time in which a "material change" could occur. Also, the taxpayer might forget the importance of continuing to satisfy the conditions for this exception to the penalty tax. *Fred Burkey, CLU, APA, The Union Central Life Insurance Company*.

Where a deferred annuity contract was exchanged for an immediate annuity contract, the purchase date of the new contract for purposes of the 10 percent penalty tax was considered to be the date upon which the deferred annuity was purchased. Thus, even if the new contract had been immediately annuitized, payments from the replacement contract did not fall within the immediate annuity exception to the penalty tax.[1]

Apparently, if an annuity contract was issued between August 13, 1982 and January 19, 1985, a distribution of income allocable to any investment made ten or more years before the distribution is not subject to the penalty. For this purpose, amounts includable in income are allocated to the earliest investment in the contract to which amounts were not previously fully allocated.[2] To facilitate accounting, investments are considered made on January 1 of the year in which they are invested.[3]

There also is a 10 percent penalty tax on certain premature distributions from life insurance policies classified as modified endowment contracts (Q 13).

The tax on premature distributions is not taken into consideration for purposes of determining the nonrefundable personal credits, general business credit, or foreign tax credit.

447. What special rules apply to premature annuity payments that are excepted from the generally-applicable 10 percent penalty by reason of the "substantially equal periodic payment" (SEPP) rule if the SEPP is later modified?

Payments excepted from the 10 percent penalty by reason of the substantially equal periodic payment exception may be subject to recapture if the series of payments is modified, other than by reason of death or disability, prior to the taxpayer's reaching age 59½ or, if later, before the end of a five year period beginning on the date of the first payment (even if the taxpayer has reached age 59½).

According to the report of the Conference Committee, the modification that triggers recapture is a change to a method of distribution that would not qualify for the exemption.

1. Rev. Rul. 92-95, 1992-2 CB 43.
2. Sec. 72(q)(1) prior to amendment by DEFRA 1984, Sec. 222(a).
3. DEFRA 1984, Sec. 222(c).

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, retroactively back to the first such distribution made had the exception never applied.[1]

The IRS announced that the three methods used to avoid the 10 percent penalty when making substantially equal periodic payments from a qualified retirement plan (Q 3631) also may be used to qualify as substantially equal periodic payments from a nonqualified annuity. The "one time election" to change methods also may be used by owners of nonqualified annuities. Finally, there will be no penalty if an individual depletes an account by using one of the approved methods.[2]

448. Are dividends payable on an annuity contract taxable income?

Taxation of dividends under an annuity contract depends on when the contract was purchased. If the contract was purchased after August 13, 1982, dividends received before the annuity starting date are taxable to the extent the cash value of the contract (determined without regard to any surrender charge) immediately before the dividend is received exceeds the investment in the contract at the same time. If there is no excess of cash value over the investment in the contract (i.e., no gain), further dividends are treated as a tax-free recovery of investment. If the annuity contract was purchased before August 14, 1982, and no additional investment was made in the contract after August 13, 1982, the dividends will be taxed like dividends received under life insurance contracts (generally tax-free until basis has been recovered; see Q 22).[3]

Dividends retained by the insurer as a premium, or other consideration for the contract, are not included in income.[4] Dividends paid but left with the insurer to accumulate at interest would not be considered retained as premium or consideration.

If any investment has been made after August 13, 1982 in an annuity contract entered into before August 14, 1982, dividends allocable to that investment are includable as dividends on a contract entered into after August 13, 1982.[5] Dividends received under an annuity contract with income allocable to earnings on pre-August 14, 1982, and post-August 13, 1982, investments are allocable first to investments made prior to August 14, 1982, then to income accumulated with respect to such pre-August 14, 1982 investments, then to income accumulated with respect to investments made after August 13, 1982, and finally to investments made after August 13, 1982.[6]

Dividends received after the annuity starting date (Q 460) are included in gross income regardless of when the contract was entered into or when any investment was made.[7]

1. H.R. Conf. Rep. No. 99-841 (TRA '86) *reprinted in* 1986-3 CB Vol. 4 403.
2. Notice 2004-15, 2004-9 IRB 526.
3. IRC Sec. 72(e).
4. IRC Sec. 72(e)(4)(B).
5. IRC Sec. 72(e)(5).
6. Rev. Rul. 85-159, 1985-2 CB 29.
7. IRC Sec. 72(e)(2)(A).

A special exception applies to annuity contracts purchased by a qualified pension, profit sharing or stock bonus plan, an individual retirement account or annuity, or a special plan of a life insurance company for its employees, or purchased as an IRC Section 403(b) tax sheltered annuity (Q 3859).

449. What is the tax treatment of dividends where annuity values are paid in installments or as a life income?

Dividends received before the annuity start date or the first date that an amount is received as an annuity, whichever is later, are subtracted from the consideration paid (i.e., the cost basis) of the annuity and are not taxable. If the investment in the contract is reduced all the way to $0, any further dividends received become taxable. Notably, the reduction in the investment in the contract as dividends are reduced applies both for determining the taxation of the dividends themselves, and also the investment in the contract for the purposes of determining the exclusion ratio if the contract is subsequently annuitized.[1]

Dividends received after the annuity start date or the first date that an amount is received as an annuity, whichever is later, are included in full in the recipient's gross income. Contrary to the case where dividends were received prior to the annuity start date, the exclusion ratio (discussed in Q 450) is not affected by dividends received after the annuity start date. The exclusion ratio in place prior to payment of the dividend continues to apply.[2]

Amounts Received as an Annuity: Fixed Annuities

Basic Rule

450. How are annuity payments taxed?

The basic rule for taxing annuity payments (i.e., "amounts received as an annuity") is designed to return the purchaser's investment in equal tax-free amounts over the payment period (e.g., the annuitant's life expectancy or a guaranteed certain period of time) and to tax the balance of each payment received as earnings. Each payment, therefore, is part nontaxable return of cost and part taxable income. Any excess interest (dividends) added to the guaranteed payments is reportable as income for the year received.

Non-Variable Contracts

For non-variable contracts, an exclusion ratio (which may be expressed as a fraction or as a percentage) must be determined for the contract. This exclusion ratio is applied to each annuity payment to find the portion of the payment that is excludable from gross income. The balance of the guaranteed annuity payment is includable in gross income for the year received.[3]

1. Treas. Reg. §1.72-11(b)(1).
2. Treas. Reg. §1.72-11(b)(2).
3. IRC Sec. 72(b)(1).

The exclusion ratio of an individual whose annuity starting date (Q 460) is after December 31, 1986 applies to payments received until the payment in which the investment in the contract is fully recovered (generally, at life expectancy). In that payment, the amount excludable is limited to the balance of the unrecovered investment. Payments received thereafter are fully includable in income, as all cost basis has been recovered at that point.[1] By contrast, the exclusion ratio as originally determined for an annuity starting date before January 1, 1987 applies to all payments received throughout the entire payment period, even if the annuitant has recovered his or her investment. Thus, it is possible for a long-lived annuitant with a pre-January 1, 1987, annuity to receive tax-free "return of principal" amounts which in the aggregate exceed the principal (investment in the contract).

The exclusion ratio for a particular contract is the ratio that the total investment in the contract (Q 456) bears to the total expected cumulative return payments (known in this case as the "expected return") (Q 459) under the contract. By dividing the investment in the contract by the expected return, the exclusion ratio can be expressed as a percentage (which the regulations indicate should be rounded to the nearest tenth of a percent).[2]

For example, assuming that the investment in the contract is $12,650 and expected return is $16,000 (e.g., $800/year for 20 years), the exclusion ratio is $12,650/$16,000, or 79.1 percent (79.06 rounded to the nearest tenth of a percent). If the monthly payment is $100, the portion to be excluded from gross income is $79.10 (79.1 percent of $100), and the balance of the payment is included in the gross income. If twelve such monthly payments are received during the taxable year, the total amount to be excluded for the year is $949.20 (12 × $79.10), and the amount to be included in income is $250.80 ($1,200 – $949.20). Excess interest, if any, also must be included.

If the investment in the contract equals or exceeds the expected return, the full amount of each payment is received tax-free.[3]

There are a few circumstances that may require the computation of a new exclusion ratio for the contract (see "Withdrawals," Q 471; "Variable annuities," Q 478; and "Sale of contract," Q 494).

For application of the basic annuity rule to various types of fixed annuity payments, see Q 461 to Q 470. If an annuity contract is owned by a non-natural person, see Q 439.

Variable Contracts

The exclusion ratio described above does not apply to payments made under a variable contract, as the expected return cannot be known in advance. For tax treatment of variable annuity payments that are received as an annuity, see Q 474 to Q 478.

1. IRC Sec. 72(b)(2).
2. Treas. Reg. §1.72-4(a)(2).
3. Treas. Reg. §1.72-4(d)(2).

451. How are annuity payments taxed to a beneficiary if an annuitant under a life annuity payout with a refund feature dies and there is value remaining in the refund feature?

If an annuitant under a life annuity payout with a refund feature dies and there is value remaining in the refund feature, the taxation of payments to the beneficiary under the refund feature depends on whether that beneficiary elects a new payout arrangement.

If proceeds under the refund feature are taken by the beneficiary either as a lump sum or in accordance with the annuity payout option under which the annuitant's payments were calculated, proceeds will be excludable from income until the total amount the beneficiary receives, when added to the amounts received tax-free by the annuitant, is equal to the annuitant's "investment in the contract," unadjusted for the value of the refund feature.[1] This "FIFO" (first-in, first-out) basis-first treatment of beneficiary payments is different than the income/gains-first treatment applying to "amounts not received as an annuity" and from the "regular annuity rules" treatment that normally applies to annuitized payments.

If the total payments thus made to the beneficiary are less than the annuitant's investment in the contract and the annuitant's annuity starting date was after July 1, 1986, the beneficiary may take an income tax deduction for any such unrecovered investment.[2]

452. What are the tax consequences if a taxpayer wishes to annuitize only a portion of an annuity contract?

Previously, the owner of an annuity or life insurance contract who wanted to annuitize a portion of a contract was required to split a contract into two and annuitize one of the resulting contracts. Splitting the contract was treated as a partial withdrawal and the owner was taxed prior to annuitization. As of 2011, that cumbersome two-step process is no longer necessary.

That's because President Obama signed the Small Business Jobs and Credit Act of 2010, (H.R. 5297). Section 2113 of the law amended IRC Section 72(a) to permit partial annuitization of annuity, endowment, and life insurance contracts – leaving the balance unannuitized – as long as the annuitization period is for ten years or more or is for the lives of one or more individuals.

When a contract is partially annuitized: (1) each annuitized portion of the contract is treated as a separate contract; (2) for purposes of calculating the taxable portion of annuity payments from a partially annuitized contract, investment in the contract is allocated pro rata between each portion of the contract from which amounts are received as an annuity and the portion of the contract from which amounts are not received as an annuity; and (3) each separately annuitized portion of the contract will have a separate annuity start date.[3]

Partial annuitization is permissible for tax years beginning after December 31, 2010.

1. Treas. Reg. §1.72-11(c).
2. IRC Sec. 72(b)(3)(A).
3. IRC Sec. 72(a)(2).

453. What is a fixed annuity?

A fixed annuity is one that is issued under a contract where the insurance company fixes the rate, for a specified period, at which income will accrue to the account. The fixed rate is determined by the company and is based upon its projection of current investment market conditions. (Any variance between the fixed rate and what the insurance company actually earns for the year is absorbed by the company.) Most contracts include a guaranteed minimum rate, below which the fixed annual return may not go.

454. What is a market value adjusted annuity?

A market value adjusted annuity (MVA) is an annuity issued pursuant to a contract that allows the carrier to adjust the product's cash surrender value upward or downward if the client chooses to surrender the product before maturity. The adjustment is calculated based on the difference between the interest rate guaranteed under the particular contract and the then-prevailing market interest rates.

Generally, if the prevailing interest rate at the time of surrender is higher than the contract's guaranteed rate, the client's cash surrender value will be adjusted downward. On the other hand, if rates move lower than the rate guaranteed under the contract, the client can receive a surrender value that may be more than the original investment—the surrender value will be increased to reflect the higher annuity rate.

As with other fixed annuities, if a client purchases a fixed MVA annuity and holds it for the duration of the product's guarantee period—which may be as short as three years or upwards of fifteen years—the product simply pays the guaranteed rate.

In recent years, the prevailing interest rates have been so low that annuity carriers have only been able to offer products with similarly low guaranteed interest rates, so there was very little difference to be realized with MVA annuities. Because interest rates on some investments—including many of those commonly held by the carriers themselves—have begun to creep higher, carriers have likewise started to offer higher rates on certain products.

This rise in interest rates, whether fleeting or long-term, allows taxpayers to lock in a higher rate on their annuity product—in some cases, for a period that is as short as three to five years. If rates begin to drop and the taxpayer chooses to surrender the product, he or she can take advantage of the MVA feature.

Further, annuity carriers often offer taxpayers higher interest rates with MVA annuities than with other annuity products because the taxpayer bears the interest rate risk; therefore, even if interest rates remain relatively stable during the guarantee period and the taxpayer holds the product to maturity, he or she may have locked in a higher interest rate than would be available with similarly conservative investment products.

455. What is an indexed annuity?

An indexed annuity is generally a fixed annuity, either immediate or deferred, that earns interest or provides benefits that are linked to an external equity reference or an equity index.

Sales of indexed annuities have grown considerably in recent years. One of the most important features of an indexed annuity is the method used to calculate the gain in the index to which the annuity is linked.

Indexed annuities have characteristics of both fixed and variable annuities. Their return varies more than a fixed annuity, but not as much as a variable annuity. Thus indexed annuities contain more risk (but have more potential for a greater return) than a fixed annuity. Indexed annuities also offer a minimum guaranteed interest rate combined with an interest rate linked to a market index. Because of the guaranteed interest rate, indexed annuities have less market risk than variable annuities and have the potential to earn higher returns than traditional fixed annuities in a rising stock market. For example, many single premium deferred annuity contracts guarantee the minimum value will never be less than 90 percent of the premium paid, plus at least 3 percent in annual interest (less any partial withdrawals). The guaranteed value is the minimum amount available during a term for withdrawals, annuitizations and death benefits.

The index-linked gain depends on the particular combination of indexing features that a particular indexed annuity uses. The most common indexing features are listed below.

Participation Rates: The participation rate decides how much of the increase in the index will be used to calculate index-linked interest. For example, if the calculated change in the index is 9 percent and the participation rate is 70 percent, the index-linked interest rate is 6.3 percent (9% × 70% = 6.3%). A company may set a different participation rate for newly issued annuities daily. The initial participation rate is typically guaranteed for a specific period. Some indexed annuities guarantee that the participation rate will never be set lower than a specified minimum or higher than a specified maximum.

Spread/Margin/Administrative Fee: Some indexed annuities use a spread, margin or administrative fee in addition to, or instead of, a participation rate. This percentage will be subtracted from any gain in the index linked to the annuity. For example, if the index gained 10 percent and the spread/margin/asset fee is 3.5 percent, then the gain in the annuity would be only 6.5 percent

Interest Rate Caps. Some indexed annuities may put a cap or upper limit on total return. This cap rate is generally stated as a percentage. This is the maximum rate of interest the annuity will earn. For example, if the index linked to the annuity gained 10 percent and the cap rate was 8 percent, then the gain in the annuity would be 8 percent. (Note that indexed annuities that have caps may have a higher a participation rate.)

Some indexed annuity contracts allow the insurance company to change participation rates, cap rates, or spread/margin/administrative fees annually or at the start of the next contract term.

456. How can the investment in the contract be determined for purposes of the annuity rules?

Generally speaking, the investment in the contract is the gross premium cost or other consideration paid for the contract, reduced by amounts previously received under the contract to the extent they were excludable from income (i.e., to the extent principal has already been returned).[1]

Unless the contract has been purchased from a previous owner, the investment in the contract normally is the amount of premiums that have been paid into the contract (also known as "premium cost").[2]

However, in some cases adjustments must be made to the premiums to determine investment in the contract. For instance, extra premiums paid for supplementary benefits such as accidental death benefit, disability income benefit, and disability waiver of premiums must be excluded from premium cost.[3] (But see *Moseley v. Comm.*,[4] where life insurance policy premium payments paid into a special reserve account were added to the aggregate premiums for purposes of calculating taxable income when a lifetime distribution was made). Further, it might seem that premiums waived on account of disability should be treated as part of the premium cost. In the only case on the subject, however, a case dealing with the computation of gain on a matured endowment, the court held that waived premiums could not be included in the taxpayer's cost basis. The court refused to accept the view of the taxpayer that the waived premiums had been constructively received as a tax-free disability benefit and then applied to the payment of premiums. Instead, the court treated a portion of the proceeds as the tax-free disability benefit: the difference between the amount of premiums actually paid and the face amount of the endowment.[5]

Investment in the contract is increased by any amount of a policy loan that was includable in income as an amount received under the contract (Q 441).[6] Any un-repaid policy loans must be subtracted from gross premiums in determining the investment in the contract for purposes of the exclusion ratio.[7]

If premiums were deposited in advance and discounted, only the amount actually paid is includable in premium cost. However, any increment in the advance premium deposit fund that has been reported as taxable income may be added to the discounted premiums in determining cost.[8]

In the case of a participating annuity contract, dividends must be taken into account as follows:

If dividends have been received in cash or used to reduce premiums, the aggregate amount of such dividends received or credited before the annuity payments commenced must be subtracted from gross premiums to the extent the dividends were excludable from gross income (Q 10, Q 441). Also, any dividends that have been applied against principal or interest on policy loans must be subtracted, but only to the extent they were excludable from gross income.[9]

1. IRC Sec. 72(c).
2. *Stoddard v. Comm.*, TC Memo 1993-400.
3. Rev. Rul. 55-349, 1955-1 CB 232; *Est. of Wong Wing Non v. Comm.*, 18 TC 205 (1952).
4. 72 TC 183 (1979).
5. *Est. of Wong Wing Non*, supra.
6. IRC Sec. 72(e)(4).
7. Treas. Reg. §1.72-6.
8. Rev. Rul. 65-199, 1965-2 CB 20.
9. Treas. Reg. §1.72-6.

(Excludable dividends are considered as a partial refund of premiums and therefore as a reduction in the cost of the contract).

If excludable dividends have been left on deposit with the insurance company to accumulate at interest and the dividends and interest are used to produce larger annuity payments, such dividends are not subtracted from gross premiums but are part of the cost of the larger payments. In this situation, gross premiums plus accumulated interest constitute the cost of the contract. (The interest is included as additional cost because it already has been taxed to the policyholder as it was credited from year to year). Likewise, any terminal dividend that is applied to increase the annuity payments should not be subtracted from gross premium cost.

Similarly, where dividends have been applied to purchase paid-up additional insurance, and the annuity payments include income from the paid-up additions, gross premiums are used as the cost of the contract. (In effect, the dividends constitute the cost of the income from the paid-up additions).

Cost Other than Premium Cost

There are other less common situations where investment in the contract is not always equal to premium cost. For example, investment in the contract may be the maturity value or cash surrender value of the contract if such value has been constructively received by the policyholder (Q 52, Q 513). If the contract has been purchased from a previous owner, the investment in the contract is the consideration paid by the purchaser (Q 43, Q 494). Also, special rules apply in computing the investment in the contract with respect to employee annuities, that is, annuities on which an employer has paid all or part of the premiums (Q 3531, Q 3864, Q 3958).

457. Does the presence of a long-term care rider to an annuity contract impact the calculation of investment in the contract for purposes of the annuity rules?

For contracts issued after 1996, but only for tax years after 2009, a charge against the cash surrender value of an annuity contract or life insurance contract for a premium payment of a qualified long-term care contract (Q 424) that is a rider to the annuity or life insurance contract reduces the investment in the contract of the annuity or life insurance contract. This charge against the cash surrender value, however, does not cause the taxpayer to recognize gross income (because it is applied against the cost basis).[1] On the other hand, such charges are also not eligible for a medical expense deduction under Section 213(a).[2]

458. Does the calculation of a taxpayer's investment in the contract for purposes of the annuity rules change if an annuity is a life annuity with a refund or period-certain guarantee?

If an annuity is a life annuity with a refund or period-certain guarantee, a special adjustment must be made to the investment in the contract (whether premium cost or other cost).

1. IRC Sec. 72(e)(11).
2. IRC Sec. 7702B(e)(2).

The value of the refund or period-certain guarantee (as determined by use of a prescribed annuity table, Table III or Table VII, or a formula, depending on when the investment in the contract was made, see Appendix A) must be subtracted from the investment in the contract. It is this adjusted investment in the contract that is used in the exclusion ratio (Q 461, Q 465).[1]

459. How is expected return computed under the annuity rules?

Generally speaking, expected return is the total amount that the annuitant or annuitants can expect to receive over the annuitization period of the contract.

Non-Variable Contracts

If payments are for a fixed period or a fixed amount with no life expectancy involved, expected return is the sum of the guaranteed payments (Q 470).[2]

If payments are to continue for a life or lives, expected return is derived by multiplying the sum of one year's annuity payments by the life expectancy of the measuring life or lives. The life expectancy multiple or multiples must be taken from the Annuity Tables prescribed by the IRS.[3] (See Appendix A for IRS Annuity Tables).

Generally, gender-based Tables I – IV are to be used if the investment in the contract does not include a post-June 30, 1986 investment. Unisex Tables V – VIII are to be used if the investment in the contract includes a post-June 30, 1986 investment. Transitional rules permit an irrevocable election to use the unisex tables even where there is no post-June 1986 investment and, if investment in the contract includes both a pre-July 1986 investment and a post-June 1986 investment, an election may be made in some situations to make separate computations with respect to each portion of the aggregate investment in the contract using, with respect to each portion, the tables applicable to it.[4] See Appendix A for details.

The life expectancy for a single life is found in Table I or in Table V, whichever is applicable (Q 461). The life expectancy multiples for joint and survivor annuities are taken from Tables II and IIA or Tables VI and VIA, whichever are applicable (Q 464 to Q 467).[5]

The Annuity Tables are entered with the age of the measuring life as of his or her birthday nearest the annuity starting date (Q 460). The multiples in the Annuity Tables are based on monthly payments. Consequently, where the annuity payments are to be received quarterly, semi-annually, or annually, the multiples from Tables I, II, and IIA or, as applicable, Tables V, VI, and VIA, must be adjusted. This adjustment is made by use of the Frequency of Payment Adjustment Table (Appendix A). No adjustment is required if the payments are monthly.

1. IRC Sec. 72(c)(2); Treas. Reg. §1.72-7.
2. IRC Sec. 72(c)(3)(B); Treas. Reg. §1.72-5(c).
3. IRC Sec. 72(c)(3).
4. Treas. Reg. §1.72-9.
5. Treas. Regs. §§1.72-5(a), 1.72-5(b).

Variable Contracts

The expected return of a variable contract cannot be known in advance. Therefore, the calculation of the amount excludable from each year's annuity payment does not employ the "exclusion ratio" used with fixed annuities. Instead, with a variable contract, the investment in the contract is divided over the period across which annuity payments will persist (Q 476).

460. What is the annuity starting date?

The annuity starting date is the "first day of the first period for which an amount is received as an annuity."[1] For a deferred annuity, the annuity starting date is triggered when the annuity owner elects to annuitize and begin payments; a deferred annuity contract also specifies an annuity starting date by which annuitization payments must begin, if the owner has not elected to start them prior to such date.

Planning Point: The annuity starting date is important not only to determine the onset of payments themselves, but also because the exclusion ratio for taxing annuity payments under a particular contract is determined as of the annuity starting date.

For an immediate annuity, the annuity starting date is generally immediate upon the purchase of the contract. For example, suppose that a person purchases an immediate annuity on July 1 providing for monthly payments beginning August 1. The annuity starting date is July 1 (the first payment is for the one month period beginning July 1). Payments under settlement options usually commence immediately rather than at the end of the month or other payment period; hence the annuity starting date is the date of the first payment.

Life Annuity: Single

461. How is the excludable portion of payments under a single life annuity computed?

The following steps are taken in applying the basic annuity rule in order to determine the portion of payments that may be excludable from income in the case of a straight life annuity:

(1) Determine the investment in the contract (Q 456).

(2) Find the life expectancy multiple in Table I or V, whichever is applicable for a person of annuitant's age (and sex, if applicable) (Appendix A). Multiply the sum of one year's guaranteed annuity payments by the applicable Table I or Table V multiple. For non-variable contracts, this is the expected return under the contract. For variable contracts, the "expected return" is the investment in the contract divided by the number of years over which payments will persist (Q 476).

(3) Divide the investment in the contract by the expected return under the contract, carrying the quotient to three decimal places. This is the exclusion ratio expressed as a percentage ("exclusion percentage").

1. IRC Sec. 72(c)(4); Treas. Reg. §1.72-4(b).

(4) Apply the exclusion percentage to the annuity payment. The result is the portion of the payment that is excludable from gross income. The balance of the payment must be included in gross income. If the annuity starting date is after December 31, 1986, the exclusion percentage applies to payments received only until the investment in the contract is recovered. However, if the annuity starting date was before January 1, 1987, the same exclusion percentage applies to all payments received throughout the annuitant's lifetime.[1]

Example 1: On October 1, 2014, Mr. Brown purchased an immediate non-refund annuity that will pay him $125 a month ($1,500 a year) for life, beginning November 1, 2014. He paid $16,000 for the contract. Mr. Brown's age on his birthday nearest the annuity starting date (October 1) was 68. According to Table V (which he uses because his investment in the contract is post-June 1986), his life expectancy is 17.6 years. Consequently, the expected return under the contract is $26,400 (12 × $125 × 17.6). The exclusion percentage for the annuity payments is 60.6 percent ($16,000 ÷ $26,400). Because Mr. Brown received two monthly payments in 2014 (a total of $250), he will exclude $151.50 (60.6 percent of $250) from his gross income for 2014, and he must include $98.50 ($250 – $151.50). Mr. Brown will exclude the amounts so determined for 17.6 years. In 2014, he could exclude $151.50; each year thereafter through 2030, he could exclude $909, for a total exclusion of $15,604.50 ($151.50 excluded in 2014 and $15,453 excluded over the next 17 years). In 2031, he could exclude only $395.50 ($16,000 – $15,604.50), which is all the investment in the contract he has left. In 2031, he would include in his income $1,104.50 ($1,500 – $395.50). In 2032 and each year thereafter, all cost basis has been recovered, and he would include $1,500 in income each year.

Example 2: If Mr. Brown purchased the contract illustrated above on October 1, 1986 (so that it had an annuity starting date before January 1, 1987), he would exclude $151.50 (60.6 percent of $250) from his 1986 gross income and would include $98.50 ($250 – $151.50). For each succeeding tax year in which he receives twelve monthly payments (even if he outlives his life expectancy of 17.6 years), he will exclude $909 (60.6 percent of $1,500), and he will include $591 ($1,500 – $909), even after 17.6 years' worth of payments have been made.

To calculate the excludable portion for an annuity contract with a refund or period-certain guarantee, see Q 462.

462. How is the excludable portion of payments under an annuity with a single life refund or period-certain guarantee calculated?

The computation outlined in Q 461 is for a straight life annuity (without a refund or period-certain guarantee). The exclusion ratio for a single life refund or period-certain guarantee is determined in the same way, but the investment in the contract first must be adjusted by subtracting the value of the refund or period-certain guarantee. The value of the refund or period-certain guarantee is computed by the following steps:

(1) Determine the duration of the guaranteed amount (number of years necessary for the total guaranteed return to be fully paid). In the case of a period-certain life annuity, the duration of the guaranteed amount, in years, is known (e.g., ten, fifteen, or twenty "years certain"). To find the duration of the guaranteed amount, in years, for a cash or installment refund life annuity, divide the total guaranteed amount by the amount of one year's annuity payments, and round the quotient to the nearest whole number of years.

1. IRC Sec. 72(b)(2).

(2) Find the factor in Table III or VII (whichever is applicable, depending on when the investment is made in the contract) under the whole number of years (as determined above) and the age and (if applicable) the sex of the annuitant (see Appendix A). This Table III or Table VII factor is the percentage value of the refund or period-certain guarantee.

(3) Apply the applicable Table III or Table VII percentage to the smaller of (a) the investment in the contract, or (b) the total guaranteed return under the contract. The result is the present value of the refund or period-certain guarantee.

(4) Subtract the present value of the refund or period-certain guarantee from the investment in the contract. The remainder is the adjusted investment in the contract to be used in the exclusion ratio.[1]

Example 3: On January 1, 2014, a husband, age sixty-five, purchases for $21,053 an immediate installment refund annuity that pays $100 a month for life. The contract provides that in the event the husband does not live long enough to recover the full purchase price, payments will be made to his wife until the total payments under the contract equal the purchase price. The investment in the contract is adjusted for the purpose of determining the exclusion ratio as follows:

Unadjusted investment in the contract	$ 21,053
Amount to be received annually	$ 1,200
Duration of guaranteed amount ($21,053 ÷ $1,200)	17.5 yrs.
Rounded to nearest whole number of years	18
Percentage value of guaranteed refund (Table VII for age 65 and 18 years)	15%
Value of refund feature rounded to nearest dollar (15% of $21,053)	$ 3,158
Adjusted investment in the contract ($21,053 – $3,158)	$ 17,895

Example 4: Assume the contract in Example 3 was purchased as a deferred annuity, the pre-July 1986 investment in the contract is $10,000, and the post-June 1986 investment in the contract is $11,053. If the annuitant elects (as explained in Appendix A) to compute a separate exclusion percentage for the pre-July 1986 and the post-June 1986 amounts, separate computations must be performed to determine the adjusted investment in the contract. The pre-July 1986 investment in the contract and the post-June 1986 investment in the contract are adjusted for the purpose of determining the exclusion ratios in the following manner:

Pre-July 1986 adjustment:

Unadjusted investment in the contract	$10,000
Allocable part of amount to be received annually	
(($10,000 ÷ $21,053) × $1,200)	$570
Duration of guaranteed amount ($10,000 ÷ $570)	17.5 yrs.
Rounded to nearest whole number of years	18
Percentage in Table III for age 65 and 18 years	30%
Present value of refund feature rounded to nearest dollar	
(30% of $10,000)	$3,000
Adjusted pre-July 1986 investment in the contract ($10,000 – $3,000)	$7,000

1. Treas. Reg. §1.72-7(b).

Post-June 1986 adjustment:	
Unadjusted investment in the contract	$11,053
Allocable part of amount to be received annually	
(($11,053 ÷ $21,053) × $1,200)	$630
Duration of guaranteed amount ($11,053 ÷ $630)	17.5 yrs.
Rounded to nearest whole number of years	18
Percentage in Table VII for age 65 and 18 years	15%
Present value of refund feature rounded to nearest dollar)	
(15% of $11,053)	$1,658
Adjusted post-June 1986 investment in the contract ($11,053 – $1,658)	$9,395

Once the investment in the contract has been adjusted by subtracting the value of the refund or period-certain guarantee, an exclusion ratio is determined in the same way as for a straight life annuity. The expected return is computed, then the adjusted investment in the contract is divided by expected return. Taking the two examples above, the exclusion ratio for each contract is determined as follows.

Example (3) above.

Investment in the contract (adjusted for refund guarantee)	$17,895
One year's guaranteed annuity payments (12 × $100)	$1,200
Life expectancy from Table V, age 65	20 yrs.
Expected return (20 × $1,200)	$24,000
Exclusion ratio ($17,895 ÷ $24,000)	74.6%
Amount excludable from gross income each year in which 12 payments are received (74.6% of $1,200)*	$895.20
Amount includable in gross income ($1,200 – $895.20)*	$304.80

* Since the annuity starting date is after December 31, 1986, the total amount excludable is limited to the investment in the contract; after that has been recovered, the remaining amounts received are includable in income. However, if the annuity has a refund or guarantee feature, the value of the refund or guarantee feature is not subtracted when calculating the unrecovered investment.[1]

Example (4) above.

Pre-July 1986 investment in the contract (adjusted for period certain guarantee)	$7,000
One year's guaranteed annuity payments (12 × $100)	$1,200
Life expectancy from Table I, male age 65	15 yrs.
Expected return (15 × $1,200)	$18,000
Exclusion ratio ($7,000 ÷ $18,000)	38.9%
Post-June 1986 investment in the contract (adjusted for period certain guarantee)	$9,395
One year's guaranteed annuity payments (12 × $100)	$1,200
Life expectancy from Table V, age 65	20 yrs.

1. IRC Sec. 72(b)(4).

Expected return (20 × $1,200)	$24,000
Exclusion ratio ($9,395 ÷ $24,000)	39.1%
Sum of pre-July and post-June 1986 ratios	78%
Amount excludable from gross income each year in which twelve payments are received (78% of $1,200)*	$936
Amount includable in gross income ($1,200 – 936)*	$264

* Since the annuity starting date is after December 31, 1986, the total amount excludable is limited to the investment in the contract; after that has been recovered, the remaining amounts received are includable in income.

Life Annuity: Temporary

463. How is a temporary life annuity taxed?

A temporary life annuity is one that provides for fixed payments until the death of the annuitant or until the expiration of a specified number of years, whichever occurs earlier. The basic annuity rule (Q 450) applies. That is, the investment in the contract is divided by the expected return under the contract to find the portion of each payment that can be excluded from gross income (the exclusion ratio). Expected return is determined by multiplying one year's annuity payments by the multiple in Table IV or Table VIII (whichever is applicable, as explained in Appendix A) of the IRS Annuity Tables for the annuitant's age (as of the annuity starting date) and sex (if applicable) and the whole number of years in the specified period.[1] Tables IV and VIII can be found in §1.72-9 of the Treasury Regulations.

The penalty tax of IRC Section 72(q) may be imposed on the taxable portion of payments received under the contract unless one of the exceptions listed in Q 446 is met.

Life Annuity: Joint and Survivor

464. How can one calculate the excludable portion of payments under a joint and survivor annuity that continues distributing the same income to the survivor as was payable while both annuitants were alive?

Non-Variable Contracts

The basic annuity rule (Q 450) applies: the investment in the contract is divided by the expected return under the contract to find the portion of each payment that can be excluded from gross income (the exclusion ratio). Expected return must be computed by using a life expectancy multiple from Table II or Table VI of the IRS Annuity Tables (see Appendix A). With respect to an annuity with a starting date after December 31, 1986, the exclusion ratio applies to payments received until the investment in the contract is recovered.[2] If the annuity starting date was before January 1, 1987, the exclusion ratio as originally computed applies to all payments received under the contract, including payments received by the survivor as well as those received while both annuitants were alive, even if the cost basis has been fully recovered.

1. Treas. Reg. §1.72-5(a)(3).
2. IRC Sec. 72(b)(2).

The steps in the computation of the exclusion ratio are as follows:

(1) Determine the investment in the contract (Q 456);

(2) Find the joint and survivor life expectancy multiple in Table II or Table VI (depending on when the investment in the contract was made – see Appendix A) under the sexes (if applicable) and ages of the annuitants. Multiply one year's guaranteed annuity payments by the applicable Table II or Table VI multiple. This is the expected return under the contract;

(3) Divide the investment in the contract by the expected return, carrying the quotient to three decimal places. This is the exclusion ratio expressed as a percentage (the "exclusion percentage")'

(4) Apply the exclusion percentage to the annuity payment. The result is the portion of the payment that is excludable from gross income. The balance of the payment must be included in gross income.

Example: After June 30, 1986, Mr. and Mrs. Black purchase an immediate joint and survivor annuity. The annuity will provide payments of $100 a month while both are alive and until the death of the survivor. Mr. Black's age on his birthday nearest the annuity starting date is sixty-five; Mrs. Black's, sixty-three. The single premium is $22,000.

Investment in the contract	$22,000
One year's annuity payments (12 × $100)	$1,200
Joint and survivor life expectancy multiple from Table VI (ages 65, 63)	26
Expected return (26 × $1,200)	$31,200
Exclusion ratio ($22,000 ÷ $31,200)	70.5%
Amount excludable from gross income each year in which 12 payments are received (70.5% of $1,200)*	$846
Amount includable in gross income each year ($1,200 – $846)*	$354

* If the annuity starting date is after December 31, 1986, the total amount excludable is limited to the investment in the contract; after that has been recovered, the remaining amounts received are includable in income.

Variable Contracts

The expected return, in Step 2 above, is the investment in the contract, divided by the payout period, as calculated above (Q 476).

465. How can one calculate the excludable portion of payments under a level payment joint and survivor annuity with refund or period-certain guarantee?

The exclusion ratio is determined as in Q 464, except that the investment in the contract first must be adjusted by subtracting the value of the refund or period-certain guarantee. This value is determined by following the steps below.

Investment in the Contract before July 1986

If Table II is used to determine the expected return for pre-July 1986 investment, the following method is used to determine the adjustment to the investment in the contract.[1] If Table VI is used to determine expected return for a pre-July 1986 investment, investment in the contract is adjusted using the formula for post-July 1986 investment (see subhead below).[2]

(1) Determine the duration of the guaranteed amount (the number of years necessary for the guaranteed amount to be fully paid). In the case of a period-certain and life annuity, this is the number of years in the guaranteed period (e.g., ten, fifteen, or twenty "years certain"). To find the duration of the guaranteed amount, in years, for a cash or installment refund annuity, divide the total amount guaranteed under the contract by the amount of one year's annuity payments. Round the quotient to the nearest whole number of years.

(2) If the annuitants are not of the same sex, substitute for a female a male five years younger (or for a male, a female five years older). Then find the refund percentage factors in Table III under the whole number of years, as determined in (1), and the age of each annuitant of the same sex. (For Table III factors, see Appendix A). Add these two Table III factors.

(3) Using ages of the same sex, as adjusted in (2), add to the age of the older annuitant the number of years indicated in the table below opposite the number of years by which the ages differ.

Number of years difference in age (two male annuitants or two female annuitants)	**Addition to older age in years**
0 to 1, inclusive	9
2 to 3, inclusive	8
4 to 5, inclusive	7
6 to 8, inclusive	6
9 to 11, inclusive	5
12 to 15, inclusive	4
16 to 20, inclusive	3
21 to 27, inclusive	2
28 to 42, inclusive	1
Over 42	0

(4) Find the refund percentage factor in Table III under the whole number of years as determined in (1) and the age of the older annuitant as adjusted in (3).

1. Treas. Reg. §1.72-7(c)(2).
2. Treas. Reg. §1.72-7(c)(1).

(5) Subtract the Table III factor found in (4) from the sum of the Table III factors found in (2). The balance, if any, is the percentage value of the refund or period-certain guarantee. If there is no balance, no adjustment in the investment in the contract need be made for the value of the refund or period-certain guarantee. If there is a balance, continue with the following steps.[12]

(6) Apply the percentage value of the refund or period-certain guarantee as determined in (5) to the smaller of the investment in the contract (Q 456) or the total guaranteed return under the contract. The result is the dollar value of the refund or period-certain guarantee.

(7) Subtract the dollar value of the refund or period-certain guarantee from the investment in the contract. The remainder is the adjusted investment in the contract to be used in determining the exclusion ratio.

Example: Mr. and Mrs. Green purchase an immediate joint and survivor annuity that will pay $200 a month for ten years certain and as long thereafter as either is alive. Mr. Green is seventy years old as of his birthday nearest the annuity starting date. Mrs. Green is sixty-five. The single premium is $35,000. The total guaranteed amount is $24,000.

Investment in the contract (unadjusted)			$35,000
Percentage factor from Table III for male, age 70, and 10-year guarantee		21%	
Percentage factor from Table III for male, age 60, and 10-year guarantee		11%	
Sum of percentage refund factors		32%	
Difference in years of age between two males, age 70 and 60	10		
Addition in years to older age (Table above)	5		
Percentage refund factor from Table III for male, age 75 and 10 year guarantee		29%	
Difference between percentages		3%	
Dollar value of period-certain guarantee (3% of $24,000)			720
Adjusted investment in the contract			$34,280
Table II multiple for male, age 70, and female, age 65			20.7
Expected return (20.7 × $2,400)			$49,680
Exclusion ratio ($34,280 ÷ $49,680)			69%
Excludable from gross income each year (69% of $2,400)*			$ 1,656
Includable in gross income each year ($2,400 – $1,656)*			$ 744

* If the annuity starting date is after December 31, 1986, the total amount excludable is limited to the investment in the contract. After that has been recovered, the remaining amounts received are includable in income.[1] However, if the annuity has a refund or guarantee feature, the value of the refund or guarantee feature is not subtracted when calculating the unrecovered investment.[2]

1. IRC Sec. 72(b)(4).
2. IRC Sec. 72(c)-(d).

Investment in the Contract after June 1986

Where the investment in a contract has been made after June 30, 1986, IRS regulations provide a complex formula for determining the percentage factor that was developed for a pre-July 1986 investment using the first five steps above. This percentage factor is then applied as explained in Steps 6 and 7 above.[1] The IRS will determine the amount of the adjustment on request.[2]

466. How can one compute the tax-exempt portion of payments under a joint and survivor annuity where the size of the payments will increase or decrease after the first death?

Some joint and survivor annuities provide that the size of the annuity payment will decrease after the first death, regardless of which annuitant dies first (e.g., a joint and one-half or a joint and two-thirds survivor annuity). Rarely, the joint and survivor annuity will provide for increased payments after the first death. The exclusion ratio is determined in the usual way, by dividing the investment in the contract by the expected return under the contract (Q 450). However, expected return must be computed in the following manner:[3]

(1) Find the joint and survivor multiple in Table II or Table VI (depending on when the investment in the contract was made, as explained in Appendix A) under both annuitants' ages and, if applicable, appropriate sexes. (For the Table II or Table VI factor, see Appendix A). Multiply the amount of one year's annuity payments to the survivor by this Table II or Table VI multiple.

(2) Find the joint life multiple in Table IIA or Table VIA (depending on when the investment in the contract was made) under both annuitants' ages and, if applicable, appropriate sexes. (For the Table IIA or VIA factor, see Appendix A). Determine the difference between the amount of one year's annuity payments before the first death and the amount of one year's annuity payments after the first death. Multiply this difference in amount by the multiple from Table IIA or VIA, whichever is applicable.

(3) If payments are to be smaller after the first death, the expected return is the sum of (1) and (2). If payments are to be larger after the first death, the expected return is the difference between (1) and (2).

After computing the expected return, determine the exclusion ratio under the basic annuity rule: divide the investment in the contract (Q 456) by the expected return under the contract (as computed above). This same exclusion ratio is applied to payments received before the first death and to payments received by the survivor. With respect to an annuity having a starting date after December 31, 1986, the exclusion ratio is applied to payments only until the investment

1. Treas. Reg. §1.72-7(c)(1)(i).
2. Treas. Reg. §1.72-7(c)(4).
3. Treas. Reg. §1.72-5(b)(5).

in the contract is recovered.[1] However, in the case of an annuity with a starting date prior to January 1, 1987, the exclusion ratio continues to apply to all payments made, regardless of whether investment in the contract has been fully recovered or not.

Example 1: After July 30, 1986, Mr. and Mrs. Brown buy an immediate joint and survivor annuity that will provide monthly payments of $117 ($1,404 a year) for as long as both live, and monthly payments of $78 ($936 a year) to the survivor. As of the annuity starting date he is sixty-five years old; she is sixty-three. The expected return is computed as follows.

Joint and survivor multiple from Table VI (ages 65,63)	26	
Portion of expected return (26 × $936)		$24,336.00
Joint life multiple from Table VIA (ages 65, 63)	15.6	
Difference between annual annuity payment before the first death and annual annuity payment to the survivor ($1,404 – $936)	$468	
Portion of expected return (15.6 × $468)		<u>$7,300.80</u>
Expected return		$31,636.80

Assuming that the Browns paid $22,000 for the contract, the exclusion ratio is 69.5 percent ($22,000 ÷ $31,636.80). During their joint lives the portion of each monthly payment to be excluded from gross income is $81.31 (69.5 percent of $117), or $975.72 a year. The portion to be included is $35.69 ($117 – $81.31), or $428.28 a year. After the first death, the portion of each monthly payment to be excluded from gross income will be $54.21 (69.5 percent of $78), or $650.52 a year. Of that monthly payment, $23.79 ($78 – $54.21), or $285.48 a year, will be included.

As noted above, if the annuity starting date is after December 31, 1986, the total amount excludable is limited to the investment in the contract. Thus, if Mr. Brown lives for twenty-three years, he may exclude $81.31 from each payment for twenty-two years ((12 × 22) × $81.31 = $21,465.84). In the next year, he may exclude $534.16 ($22,000 – $21,465.84) or $81.31 from each of the first six payments, but only $46.30 from the seventh. The balance is entirely includable in his income and on his death his widow must include the full amount of each payment in income.

Example 2: Assume that in the example above, there is a pre-July 1986 investment in the contract of $12,000 and a post-June 1986 investment in the contract of $10,000. Mr. Brown elects to calculate the exclusion percentage for each portion. The pre-July exclusion ratio would be 44.6 percent ($12,000 ÷ $26,910, the expected return on the contract determined by using Tables II and IIA and the age and sex of both annuitants). The post-June 1986 exclusion ratio is $10,000 ÷ $31,636.80 or 31.6 percent. The amount excludable from each monthly payment while both are alive would be $89.15 (44.6 percent of $117 plus 31.6 percent of $117) and the remaining $27.85 would be included in gross income. If the annuity starting date is after December 31, 1986, the total amount excludable is limited to the investment in the contract.

467. How is the tax-exempt portion of payments determined for a joint and survivor annuity where the size of the payments will be reduced only if a specified annuitant dies first?

In this variation of the joint and survivor annuity, payments of a stipulated amount are made for so long as a specified annuitant (for example, the husband) lives, but payments of

1. IRC Sec. 72(b)(2).

a reduced amount are made to the surviving joint annuitant (for example, the wife) for as long as the survivor lives. If the non-specified annuitant (for example, the wife) dies first, payments to the specified annuitant (for example, the husband) remain the same. The exclusion ratio for such an annuity is determined in the usual way, by dividing the investment in the contract by the expected return under the contract (Q 450). Expected return, however, must be computed in the following manner:[1]

(1) Find the joint and survivor multiple in Table II or VI (whichever is applicable, depending on when the investment in the contract was made, as explained in Appendix A) under the ages and (if applicable) the sexes of the annuitants. Then find the single life expectancy multiple in Table I or V, whichever is applicable, under the age and (if applicable) the sex of the first (specified) annuitant. (See Appendix A for Annuity Tables). Subtract the applicable Table I or Table V multiple from the applicable Table II or Table VI multiple, and multiply the amount payable annually to the second annuitant (the reduced payment) by the difference between the multiples.

(2) Multiply the amount payable annually to the first annuitant by the Table I or Table V multiple (whichever is applicable).

(3) Add the results of (1) and (2). This is the expected return under the contract.

Then proceed in the usual manner: divide the investment in the contract (Q 456) by the expected return under the contract (as computed above).

Example: After June 30, 1986, a husband and wife purchase a joint and survivor annuity providing payments of $100 a month for his life and, after his death, payments to her of $50 a month for the remainder of her life. As of the annuity starting date he is seventy years old and she is sixty-seven.

Multiple from Table VI (ages 70, 67)	22
Multiple from Table V (age 70)	16
Difference (multiple applicable to second annuitant)	6
Portion of expected return, second annuitant (6 × $600)	$ 3,600
Portion of expected return, first annuitant (16 × $1,200)	19,200
Expected return under the contract	$22,800

Assuming that the investment in the contract is $14,310, the exclusion ratio is 62.8 percent ($14,310 ÷ $22,800). While the husband lives, $62.80 of each monthly payment (62.8 percent of $100) is excluded from gross income, and the remaining $37.20 of each payment must be included in gross income. After the husband's death, the surviving wife will exclude $31.40 of each payment (62.8 percent of $50), and the remaining $18.60 of each payment will be includable in her gross income. If the annuity starting date is after December 31, 1986, the total amount excludable is limited to the investment in the contract. Thus, if the husband lives fifteen years and receives 180 payments, the unrecovered investment in the contract at his death is $3,006 ($14,310 – (180 × $62.80)). The surviving wife can exclude $31.40 for ninety-five payments, and $23 from the next one payment ($3,006 – (95 × 31.40) = $23). She may exclude nothing thereafter.

1. Treas. Reg. §1.72-5(b)(2).

468. What are the income tax consequences to the surviving annuitant under a joint and survivor annuity?

The survivor continues to exclude from gross income the same percentage of each payment that was excludable before the first annuitant's death. With respect to annuities having a starting date after December 31, 1986, the total exclusion by the first annuitant and the survivor may not exceed the investment in the contract; that is, when the entire investment in the contract has been received tax-free, the entire amount of all subsequent payments will be taxed as ordinary income (Q 464 to Q 467). However, for annuities with starting dates prior to January 1, 1987, the exclusion ratio continues to apply indefinitely to annuity payments, even if the amount of principal recovered exceeds the original investment in the contract.

In addition, if the value of the survivor annuity was subject to estate tax, the survivor may be entitled to an income-in-respect-of-a-decedent income tax deduction for a portion of the estate tax paid (attributable to the embedded gain in the contract at the time of death).[1] This deduction, in most cases, will be small.

Generally, the income-in-respect-of-a-decedent deduction is computed as follows: The portion of the guaranteed annual payment that will be excluded from the survivor's gross income (under the exclusion ratio) is multiplied by the survivor's life expectancy at the date of the first annuitant's death. The result is subtracted from the estate tax value of the survivor's annuity, thereby determining the amount of expected gain in the contract at death. The total income tax deduction allowable is the estate tax attributable to this remainder of the value of the survivor's annuity.

This total deduction is claimed pro-rata over the survivor's life expectancy as of the date of the first annuitant's death, and a prorated amount is deductible from the survivor's gross income each year as payments are received. But no further deduction is allowable after the end of the survivor's life expectancy. The foregoing treatment applies only where the primary annuitant died after 1953.[2]

Planning Point: Joint ownership of non-qualified annuities creates more problems than it solves, including forced distribution at either owner's death. Where the designated beneficiary of each owner is other than the other owner, payment, at either owner's death, generally will be made to that beneficiary, effectively (and surprisingly) "disinheriting" the surviving owner. Some annuity contracts contain language stating that if the contract is jointly owned (with a right of survivorship), the surviving owner will be deemed to be the deceased owner's primary beneficiary, notwithstanding any beneficiary designation to the contrary. Some insurers will not issue deferred annuities with joint ownership unless the owners are a married couple.

It is worth noting that joint ownership often is unnecessary to achieve the objective that the policy owners may believe requires such ownership. For example, if a husband owns, and is the annuitant of, a deferred annuity of which the wife is primary beneficiary, the death of either will leave the survivor in complete control of the contract. If the husband dies, the wife, as the surviving spouse and primary beneficiary, may receive the death benefit or treat the contract as her own under IRC Section 72(s)(3). If the wife dies first, the husband remains in full control of the contract. *John L. Olsen, CLU, ChFC, AEP, Olsen Financial Group*.

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1. IRC Sec. 691(d).
2. Treas. Reg. §1.691(d)-1.

Life Annuity: Refund Beneficiary

469. If an annuitant dies before receiving the full amount guaranteed under a refund or period-certain life annuity, is the balance of the guaranteed amount taxable income to the refund beneficiary?

The beneficiary will have no taxable income until the total amount the beneficiary receives, when added to amounts that were received tax-free by the annuitant (i.e., the excludable portion of the annuity payments), exceeds the investment in the contract. In other words, all amounts received by the beneficiary under a refund guarantee are treated as a return of principal first, and are exempt from tax until the investment in the contract has been recovered tax-free. Thereafter, receipts (if any) are taxable income. For purposes of calculating the unrecovered investment in the contract, the value of the refund or guarantee feature is not subtracted.[1] This "FIFO" treatment, for payments made to the beneficiary, is different from the "regular annuity rules" treatment that applied to payments made to the deceased annuitant.

The amount received by the beneficiary is considered paid in full discharge of the obligation under the contract in the nature of a refund of consideration and therefore comes under the cost recovery rule regardless of when the contract was entered into or when investments were made in the contract.[2] This rule applies whether the refund is received in one sum or in installments made under the *same* payout arrangement under which the deceased annuitant had been receiving payments.

If the refund or commuted value of remaining installments certain is applied anew under a *different* annuity option for the beneficiary, the payments will be taxed under the regular annuity rules. A new exclusion ratio will be determined for the beneficiary.[3]

If the refund beneficiary of an annuitant whose annuity starting date is after July 1, 1986 does not recover the balance of the investment in the contract that was not recovered by the annuitant, the beneficiary may take a deduction for the unrecovered balance (Q 492).[4]

Any payment made on or after the death of an annuity holder is not subject to the 10 percent premature distribution tax (Q 446).

Fixed Period or Fixed Amount Installments

470. How is the excludable portion of an annuity payment under a fixed period or fixed amount option computed?

Non-Variable Contracts

The basic annuity rule (Q 450) applies: Divide the investment in the contract (Q 456) by the expected return under the contract to determine the exclusion ratio for the payments. Apply this ratio to each payment to find the portion that is excludable from gross income. The balance of the payment is includable in gross income.

1. IRC Sec. 72(b)(4).
2. IRC Sec. 72(e)(5); Treas. Regs. §§1.72-11(a), 1.72-11(c).
3. IRC Sec. 72(e)(5)(E); Treas. Regs. §§1.72-11(c), 1.72-11(e).
4. IRC Sec. 72(b)(3).

If payments are for a fixed number of years (without regard to life expectancy), the expected return is the guaranteed amount receivable each year multiplied by the fixed number of years.[1]

If payments are for a fixed amount (without regard to life expectancy), the expected return is the total guaranteed amount of payments. Additional payments made after/beyond the guaranteed amount (due to excess interest) are fully taxable.[2]

To compute the excludable portion of each payment by a short method, divide the investment in the contract by the number of guaranteed payments. The result will never vary more than slightly from the exact computation.

> *Example 1*: The owner of a maturing $25,000 endowment elects to receive the proceeds in equal annual payments of $2,785 for a fixed 10 year period. Assuming that the owner's investment in the contract is $22,500, the owner may exclude $2,250 ($22,500 ÷ 10) from gross income each year. The owner must include the balance of amounts received during the year in gross income.

> *Example 2*: The owner of a maturing $25,000 endowment elects to take the proceeds in monthly payments of $200. The company's rate book shows that payments of $200 are guaranteed for 144 months. Assuming that the owner's investment in the contract is $22,500, the owner can exclude $156.25 ($22,500 ÷ 144) of each payment from gross income, and must include $43.75 ($200 – $156.25). Thus, for a full 12 months of payments, the owner excludes $1,875 (12 × $156.25) and includes $525 ($2,400 – $1,875). Additional payments received after the 144 month period are fully taxable.

If the payee dies before the guaranteed period expires, the payee's beneficiary will exclude the same portion of each payment as originally computed.[3]

A penalty tax may be imposed on any payments received under the contract unless one of the exceptions listed in Q 446 is met.

Variable Contracts

Where the annuity payout is made under a variable basis (where the amount of each payment varies with the investment performance of the annuity "separate accounts"), the expected return is the investment in the contract (Q 476). The taxable amount of each annual payment will be the excess of the amount received in that year over the investment in the contract divided by the number of years in the period-certain.

Annuity Reduced by Partial Withdrawal

471. What are the income tax results when an annuitant makes a partial lump sum withdrawal (i.e., a partial commutation) and takes a reduced annuity for the same?

The nontaxable portion of the lump sum withdrawn is an amount that bears the same ratio to the unrecovered investment in the contract as the reduction in the annuity payment bears to

1. Treas. Reg. §1.72-5(c).
2. Treas. Reg. §1.72-5(d).
3. Treas. Reg. §1.72-11(c)(2), Ex. 4.

the original payment. The original exclusion ratio will apply to the reduced payments; that is, the same percentage of each payment will be excludable from gross income.[1]

Example: Mr. Gray pays $20,000 for a life annuity paying him $100 a month. At the annuity starting date his life expectancy is twenty years. His total expected return is therefore $24,000 (20 × $1,200), and the exclusion ratio for the payment is five-sixths ($20,000/$24,000). He receives annuity payments for five years (a total of $6,000) and excludes a total of $5,000 ($1,000 a year) from gross income. At the beginning of the next year, Mr. Gray agrees with the insurer to take a reduced annuity of $75 a month and a lump sum cash payment of $4,000. He will continue to exclude five-sixths of each annuity payment from gross income; that is, $62.50 (5/6 of $75). Of the lump sum, he will include $250 in gross income and exclude $3,750, determined as follows:

Investment in the contract	$20,000
Less amounts previously excluded	5,000
Unrecovered investment	$15,000
Ratio of reduction in payment to original payment ($25/$100)	1/4
Lump sum received	$ 4,000
Less 1/4 of unrecovered investment (1/4 of $15,000)	3,750
Portion of lump sum taxable	$ 250

472. What are the income tax results when an annuitant makes a partial lump sum withdrawal and takes the same payments for a different term?

If an annuity contract was purchased before August 14, 1982 (and no additional investment was made in the contract after August 13, 1982), the lump sum withdrawn is excludable from gross income as "an amount not received as an annuity" that is a return of principal received before the annuity starting date. Thus, the lump sum is subtracted from the unrecovered premium cost, and the balance is used as the investment in the contract. A new exclusion ratio (Q 450) must be computed for the annuity payments.[2]

If the lump sum withdrawn is allocable to investment in an annuity contract made after August 13, 1982, it would appear that there will be a taxable withdrawal of interest if the cash surrender value of the contract exceeds investment in the contract (Q 441, Q 446) and a new exclusion ratio must be computed given a lower anticipated expected return due to the withdrawal of a portion of contract gains (paired with the existing investment in the contract that remains).

473. What is a variable annuity?

Variable annuities differ from fixed-dollar annuities in that the size of the payments is not guaranteed but varies according to investment experience, cost-of-living indices, or similar fluctuating criteria.

Obviously, it would not be feasible, or equitable from a revenue standpoint, to apply the regular annuity rules in taxing such payments. If investment experience were very favorable,

1. Treas. Reg. §1.72-11(f).
2. Treas. Reg. §1.72-11(e).

for example, the application of a constant exclusion ratio would result in a correspondingly increased tax-free portion.

Treasury regulations, therefore, provide special rules for taxing variable annuities. However, for taxable years beginning after December 31, 1983, a variable annuity contract will not be treated as an annuity and taxed under these rules unless the underlying investments of the segregated asset account are adequately diversified.[1]

In general, these rules provide that the amount which can be excluded from gross income in a taxable year is the portion of the investment in the contract which is allocable to that year. This is determined by dividing the investment in the contract by a multiple taken from the annuity tables which represents the anticipated number of years over which the annuity will be payable.[2] All amounts received in excess of this yearly exclusion are fully taxable. The amount so determined may be excluded from gross income each year for as long as the payments are received if the annuity starting date was before January 1, 1987 (even after the annuitant has outlived his life expectancy and recovered his cost tax-free).

In the case of an annuity contract with a starting date after 1986, the amount determined may be excluded from gross income only until the investment in the contract is recovered.[3]

Annuity Rules: Variable Annuities

474. What is a variable annuity?

Variable annuities differ from fixed-dollar annuities in that the size of the payments is not guaranteed but varies according to investment experience, cost-of-living indices, or similar fluctuating criteria.

Obviously, it would not be feasible, or equitable from a revenue standpoint, to apply the regular annuity rules in taxing such payments. If investment experience were very favorable, for example, the application of a constant exclusion ratio would result in a correspondingly increased tax-free portion. Treasury regulations, therefore, provide special rules for taxing variable annuities.

475. Is the purchaser of a deferred variable annuity taxed on the annual growth of a deferred annuity during the accumulation period?

An annuity owner who is a "natural person" will pay no income tax until he or she receives distributions from the contract. If the contract is annuitized, taxation of payments will be calculated based on the rules that apply given the annuity starting date when payments begin. Distribution amounts received "not as an annuity" – i.e., partial withdrawals or full surrenders without annuitization – prior to the annuity starting date are subject to the rules discussed in Q 441 and Q 446.

1. IRC Sec. 817(h).
2. Treas. Reg. §1.72-2(b)(3).
3. IRC Sec. 72(b)(2).

The tax deferral enjoyed by a deferred annuity owned by a natural person is not derived from any specific IRC section granting such deferral. Rather, this tax treatment is granted by implication. All distributions from an annuity are either "amounts received as an annuity" or "amounts not received as an annuity." As the annual growth of the annuity account balance, except to the extent of dividends, is not stated in the IRC to be either, it is not a "distribution," and therefore is not subject to tax as earned. For the tax treatment of dividends, see Q 441, Q 448, and Q 449.

A variable annuity contract will not be treated as an annuity and taxed as explained in this and the following questions unless the underlying investments of the segregated asset account are "adequately diversified," according to IRS regulations (Q 480).[1]

Planning Point: Notably, this does not necessarily mean that investors themselves who own such variable annuities must be diversified, but simply that they must be presented with a diversified range of options from the variable annuity contract.

If the owner of the contract is a person other than a natural person (for example, a corporation or certain trusts), growth in the value of the annuity might not be tax deferred; see Q 439.

476. How are payments under a variable immediate annuity taxed?

Both fixed dollar and variable annuity payments received as an annuitized stream of income are subject to the same basic tax rule: a fixed portion of each annuity payment is excludable from gross income as a tax-free recovery of the purchaser's investment, and the balance is taxable as ordinary income. In the case of a variable annuity, however, the excludable portion is not determined by calculating an "exclusion ratio" as it is for a fixed dollar annuity (Q 450). Because the expected return under a variable annuity is unknown, it is considered to be equal to the investment in the contract. Thus, the excludable portion of each payment is determined by dividing the investment in the contract (adjusted for any period-certain or refund guarantee) by the number of years over which it is anticipated the annuity will be paid.[2] In practice, this means that the cost basis is simply recovered pro-rata over the expected payment period.

If payments are to be made for a fixed number of years without regard to life expectancy, the divisor is the fixed number of years. If payments are to be made for a single life, the divisor is the appropriate life expectancy multiple from Table I or Table V, whichever is applicable (depending on when the investment in the contract was made, as explained in Appendix A). If payments are to be made on a joint and survivor basis, based on the same number of units throughout both lifetimes, the divisor is the appropriate joint and survivor multiple from Table II or Table VI, whichever is applicable (depending on when the investment in the contract is made; see Appendix A). IRS regulations explain the method for computing the exclusion where the number of units is to be reduced after the first death. The life expectancy multiple need not be adjusted if payments are monthly. If they are to be made less frequently

1. IRC Sec. 817(h); Treas. Reg. §1.817-5.
2. Treas. Reg. §1.72-2(b)(3).

(annually, semi-annually, quarterly), the multiple must be adjusted (see Frequency of Payment Adjustment Table, Appendix A).[1]

A portion of each payment is only excluded from gross income using the exclusion ratio until the investment in the contract is recovered (normally, at life expectancy).[2] However, if payments received are from an annuity with a starting date that was before January 1, 1987, payments continue to receive exclusion ratio treatment for life, even if the total cost basis recovered exceeds the original investment amount.

Where payments are received for only part of a year (as for the first year if monthly payments commence after January), the exclusion is a pro-rata share of the year's exclusion.[3]

If an annuity settlement provides a period-certain or refund guarantee, the investment in the contract must be adjusted before being prorated over the payment period (Q 477).

477. How is the value of a refund or period-certain guarantee determined under a variable annuity contract?

If a variable annuity settlement provides a refund or period-certain guarantee, then when calculating the exclusion ratio the investment in the contract must be reduced by the value of the guarantee.[4] The value of such a guarantee in connection with a single life annuity is determined as follows:

Find the refund percentage factor in Table III or Table VII (whichever is applicable, depending on the date the investment in the contract was made, as explained in Appendix A) under the age and (if applicable) sex of the annuitant and the number of years in the guaranteed period (see Tables in Appendix A). Where the settlement provides that proceeds from a given number of units will be paid for a period-certain and life thereafter, the number of years in the guaranteed period is clear (e.g., ten, fifteen, twenty "years certain").

If the settlement specifies a guaranteed amount, however, divide this guaranteed amount by an amount determined by placing payments received during the first taxable year (to the extent that such payments reduce the guaranteed amount) on an annual basis. Thus, if monthly payments begin in August, the total amount received in the first taxable year is divided by five, then multiplied by twelve.

The quotient is rounded to the nearest whole number of years, and is used in entering Table III or Table VII, as applicable. The appropriate Table III or Table VII multiple is applied to whichever is smaller: (a) the investment in the contract, or (b) the product of the payments received in the first taxable year, placed on an annual basis, multiplied by the number of years

1. Treas. Regs. §§1.72-2(b)(3), 1.72-4(d).
2. IRC Sec. 72(b)(2).
3. Treas. Reg. §1.72-2(b)(3).
4. Treas. Reg. §1.72-7(d).

for which payment of the proceeds of a unit or units is guaranteed. The following illustration is taken from the regulations:[1]

> *Example*: Mr. Brown, a fifty year old male, purchases for $25,000, a contract that provides for variable monthly payments to be paid to him for his life. The contract also provides that if he should die before receiving payments for fifteen years, payments shall continue according to the original formula to his estate or beneficiary until payments have been made for that period. Beginning with the month of September, Mr. Brown receives payments that total $450 for the first taxable year of receipt. This amount, placed on an annual basis, is $1,350 ($450 divided by 4 or $112.50; $112.50 multiplied by 12, or $1,350).
>
> If there is no post-June 1986 investment in the contract, the guaranteed amount is considered to be $20,250 ($1,350 × 15), and the multiple from Table III (for male fifty, fifteen guaranteed years), nine percent, applied to $20,250 (because this amount is less than the investment in the contract), results in a refund adjustment of $1,822.50. The latter amount, subtracted from the investment in the contract of $25,000, results in an adjusted investment in the contract of $23,177.50. If Mr. Brown dies before receiving payments for fifteen years and the remaining payments are made to Mr. Green, his beneficiary, Mr. Green shall exclude the entire amount of such payments from his gross income until the amounts so received by Mr. Green, together with the amounts received by Mr. Brown and excludable from Mr. Brown's gross income, equal or exceed $25,000. Any excess and any payments thereafter received by Mr. Green shall be fully includable in gross income.
>
> Assume the total investment in the contract was made after June 30, 1986. The applicable multiple found in Table VII is three percent. When this is applied to the guaranteed amount of $20,250, it results in a refund adjustment of $607.50. The adjusted investment in the contract is $24,392.50 ($25,000 – $607.50).

478. If payments from an immediate variable annuity drop below the excludable amount for any year, is the balance of the exclusion lost?

No.

If the amount received from an immediate variable annuity in any taxable year is less than the excludable amount as originally determined, the annuitant may elect to redetermine the excludable amount in a succeeding taxable year in which the annuitant receives another payment. The aggregate loss in exclusions for the prior year (or years) is divided by the number of years remaining in the fixed period or, in the case of a life annuity, by the annuitant's life expectancy computed as of the first day of the first period for which an amount is received as an annuity in the taxable year of election. The amount so determined is added to the originally determined excludable amount.[2]

Planning Point: In essence, this rule allows any investment in the contract not received in one year to be recovered pro-rata in subsequent years as subsequent payments are received.

> *Example 1*: Mr. Brown is sixty-five years old as of his birthday nearest July 1, 1985, the annuity starting date of a contract he purchased for $21,000. There is no investment in the contract after June 30, 1986. The contract provides variable monthly payments for Mr. Brown's life. Because Mr. Brown's life expectancy is fifteen years (Table I), he may exclude $1,400 of the annuity payments from his gross income each year ($21,000 ÷ 15). Assume that in each year before 1988, he receives more than $1,400, but in 1988, he receives only $800 – $600 less than his allowable exclusion. He may elect, in his return for 1989, to recompute his annual exclusion. Mr. Brown's age, as of his birthday nearest the first period for which he receives an annuity payment in 1989 (the year of election) is sixty-nine, and the life expectancy for that age is 12.6. Thus, he

1. Treas. Reg. §1.72-7(d)(2).
2. Treas. Reg. §1.72-4(d)(3).

may add $47.61 to his previous annual exclusion, and exclude $1,447.61 in 1989 and subsequent years. This additional exclusion is obtained by dividing $600 (the difference between the amount he received in 1988 and his allowable exclusion for that year) by 12.6.

Example 2: Mr. Green purchases a variable annuity contract that provides payments for life. The annuity starting date is June 30, 2011, when Mr. Green is 64 years old. Mr. Green receives a payment of $1,000 on June 30, 2012, but receives no other payment until June 30, 2014. Mr. Green's total investment in the contract is $25,000. Mr. Green's pre-July 1986 investment in the contract is $12,000. Mr. Green may redetermine his excludable amount as above, using the Table V life expectancy. If, instead, he elects to make separate computations for his pre-July 1986 investment and his post June-1986 investment (see Appendix A), his additional excludable amount is determined as follows.

Pre-July 1986 investment in the contract allocable to taxable years 2012 and 2013 ($12,000 ÷ 15.1 [multiple from Table I for a male age 64] = $794.70;	$1,589.40
Less: portion of total payments allocable to pre-July 1986 investment in the contract actually received as an annuity in 2012 and 2013 ($12,000/$25,000 × $1,000)	480.00
Difference	$1,109.40
Post-June 1986 investment in the contract allocable to taxable years 2012 and 2013 ($13,000 ÷ 20.3 [multiple from Table V for male age 64] = $640.39; $640.39 × 2 years = $1,280.78	$1,280.78
Less portion of total payments allocable to post-July 1986 investment in the contract actually received as an annuity in 2012 and 2013 ($13,000/$25,000 × $1,000)	520.00
Difference	$ 760.78

Because the applicable portions of the total payment received in 2012 under the contract ($480 allocable to the pre-July 1986 investment in the contract and $520 allocable to the post-June 1986 investment in the contract) do not exceed the portion of the corresponding investment in the contract allocable to the year ($794.70 pre-July 1986 and $640.39 post-June 1986) the entire amount of each applicable portion is excludable from gross income and Mr. Green may redetermine his excludable amounts as follows:

Divide the amount by which the portion of total payment actually received allocable to pre-July 1986 investment in the contract is less than the pre-July 1986 investment in the contract allocable to 2012 and 2013 ($1,109.40) by the life expectancy under Table I for Mr. Green, age 66 (14.4 – .5 [frequency multiple]; $1,109.40 ÷ 13.9)	$ 79.81
Add the amount originally determined with respect to pre-July 1986 investment in the contract	794.70
Amount excludable with respect to pre-July 1986 investment	$874.51
Divide the amount by which the portion of total payment actually received allocable to post-June 1986 investment in the contract is less than the post-June 1986 investment in the contract allocable to 2012 and 2013 ($760.78) by the life expectancy under Table V for Mr. Green, age 66 (19.2 – .5 [frequency multiple]; $760.78 ÷ 18.7)	$ 40.68
Add the amount originally determined with respect to post-June 1986 investment in the contract	640.39
Amount excludable with respect to post-June 1986 investment	$681.07

479. What is an indexed variable annuity?

Although known by several different names and subject to a broad range of potential product features, an indexed variable annuity is essentially an annuity product where investment returns are tied to the performance of one or more stock indices (e.g., the S&P 500 or the Dow Jones).

Unlike straight equity investing, however, the product itself offers a cushion against investment losses in exchange for a cap on the potential for investment gains.

The carrier may offer 10, 15, or 20 percent (or more) buffers against investment losses, meaning that if the underlying investments generate a loss, the insurance carrier absorbs a set percentage of that loss before the taxpayer experiences any loss. As such, if the chosen index declines, for example, by 10 percent and the taxpayer has chosen a 15 percent buffer, the taxpayer's account value will decline only by the 5 percent loss that exceeds the contract's downside protection.

However, as a trade-off for the downside protection afforded by these contracts, participation in the linked index's gains will be subject to a cap for a fixed term of years. Despite this, the term of years can be as short as a single year for some contracts, allowing the taxpayer a degree of flexibility that he or she might not otherwise find available in a fixed indexed annuity product. Further, some contracts provide for an upside cap that fluctuates annually—or, in some cases, as frequently as weekly or monthly.

Some insurance carriers even offer products that cover 100 percent of the downside risk of the investment, but these carriers also set the upside caps on these contracts at a lower percentage (in some cases, as low as 1.5 percent) that resets frequently (for example, every two weeks).

Despite their lack of guaranteed income, in addition to these product-specific features, indexed variable annuities continue to offer many of the benefits that traditionally accompany an annuity product, including the valuable elements of tax deferral and death benefits for account beneficiaries.

480. What is a wraparound or investment annuity? How is the owner taxed prior to the annuity starting date?

"Investment annuity" and "wraparound annuity" are terms for arrangements in which an insurance company agrees to provide an annuity funded by investment assets placed by or for the policyholder with a custodian (or by investment solely in specifically identified assets held in a segregated account of the insurer). The IRS has ruled that under these arrangements, sufficient control over the investment assets is retained by the policyholder so that income on the assets prior to the annuity starting date is currently taxable to the policyholder rather than to the insurance company, which is actually favorable in this context – it means investors can retain capital gains treatment on the underlying assets, even as they receive the guarantees associated with the annuity backing, though it also means the investor does *not* receive the annuity's tax deferral benefits.[1]

In some instances, however, the policyholder's degree of control over the investment decisions has been insufficient, so the IRS considered the insurance company, rather than the policyholder, to be the owner of the contracts. For example, the IRS has ruled that the contract

1. *Christoffersen v. U.S.*, 84-2 USTC ¶9990 (8th Cir. 1984), *rev'g* 84-1 USTC ¶9216 (N.D. Iowa 1984), *cert. denied*, 473 U.S. 905 (1985); Rev. Rul. 81-225, 1981-2 CB 12 (as clarified by Rev. Rul. 82-55, 1982-1 CB 12); Rev. Rul. 80-274, 1980-2 CB 27. Rev. Rul. 77-85, 1977-1 CB 12.

owner of a variable annuity can invest in sub-accounts that invest in mutual funds that are available only through the purchase of variable contracts without losing the variable annuity's tax deferral, but in turn will be forced to have all gains taxed as ordinary income (per the usual treatment of annuity gains).[1]

The IRS has ruled on whether the "hedge funds" within the sub-accounts of variable annuities and variable life insurance contracts will be treated as owned by the insurance company or the contract owner. Generally, if the hedge funds are available to the general public, the sub-account will be treated as owned by the contract owner and therefore not entitled to tax deferral. However, if the hedge funds are available only through an investment in the variable annuity, tax deferral is available.[2] The IRS also has clarified who is considered the "general public."[3]

With the exception of certain contracts grandfathered under Revenue Rulings 77-85 and 81-225, the underlying investments of the segregated asset accounts of variable contracts must meet diversification requirements set forth in the Regulations.[4]

481. What is a longevity annuity?

A longevity annuity – also sometimes called a "deferred income annuity" (DIA) or an Advanced Life Deferred Annuity (ALDA) – is an annuity contract that (generally) provides no cash value or death benefits during a deferral period, and begins to make annuitized payments for life at the end of that period, if the annuity owner is still alive. For instance, the contract for a 60-year-old might provide that payments will not begin until age 85, but upon reaching that age payments will be made for life; due to the long deferral period and the accumulation of significant mortality credits, the payments that ultimately begin may be very large relative to the original payment amount.

The IRS has issued a private letter ruling explaining the tax treatment of a so-called longevity annuity.[5] According to the IRS, a longevity annuity qualifies for favorable treatment, which means payments are taxed under the exclusion ratio rules when they begin.

This treatment applies as long as, on the deferral period end date, the contract's contingent account value becomes the cash value and is accessible by the owner through:

(1) the right to receive annuity payments at guaranteed rates,

(2) the right to surrender the contract for its cash value,

(3) the right to take partial withdrawals of the cash value, and

(4) a death benefit.

1. Rev. Rul. 2005-7, 2005-6 IRB 464. See also Rev. Rul. 2003-91, 2003-33 CB 347; Rev. Rul. 82-54 1982-1 CB 11.
2. Rev. Rul. 2003-92, 2003-33 CB 350.
3. Rev. Rul. 2007-7, 2007-7 IRB 468.
4. IRC Sec. 817(h); Treas. Reg. §1.817-5.
5. Let. Rul. 200939018.

The IRS concluded that a longevity annuity is an annuity contract for purposes of IRC Section 72 because the contract is in accordance with the customary practice of life insurance companies and the contract does not make periodic payments of interest.

In support of its first conclusion, the IRS noted that insurance companies historically have issued deferred annuity contracts that, like longevity annuities, did not have any cash value during the deferral stage and did not provide any death benefit or refund feature should the annuitant die during this time. Thus, in the IRS's opinion, survival of the annuitant through the deferral period is not an inappropriate contingency for the vesting of cash value and the application of annuity treatment to the proposed contract.

In reaching the second conclusion, the IRS took note of the fact that the longevity annuity (1) provides for periodic payments designed to liquidate a fund, (2) contains permanent annuity purchase rate guarantees that allow the contract owner to have the contingent account value applied to provide a stream of annuity payments for life or a fixed term at any time after the deferral period, and (3) provides for payments determined under guaranteed rates.

482. What is the difference between a longevity annuity and a deferred annuity?

A deferred annuity provides for an initial waiting period before the contract can be annuitized (usually between one and five years), and during that period the contract's cash value generally remains liquid and available (albeit potentially subject to surrender charges). Beyond the initial waiting period the contract *may* be annuitized, though the choice remains in the hands of the annuity policyowner, at least until the contract's maximum maturity age at which it must be annuitized.

Planning Point: It is *always* the case that owners of deferred annuity contracts can annuitize after an initial waiting period (often one year, and rarely later than the fifth year). This is the case even when the contract's *maturity date* is fixed at a date far into the future. John L. Olsen, CLU, ChFC, AEP.

By contrast, a longevity annuity generally has no access to the funds during the deferral period, does not *allow* the contract to be annuitized until the owner reaches a certain age (usually around 85).

In other words, many taxpayers purchase traditional deferred annuity products with a view toward waiting until old age to begin annuity payouts, but they always have the option of beginning payouts at an earlier date. With a longevity annuity, there is generally no choice, but this also allows for larger payments for those who do survive to the starting period; as a result, for those who survive, longevity annuities typically provide for a larger payout (often, much larger) than traditional deferred annuity products.

Planning Point: The chief benefit of a longevity annuity is *financial leverage*. The benefit payment may be far larger than can be *guaranteed*, at the time of purchase, by any other instrument, including a deferred annuity. As one might expect, the leverage in a longevity annuity providing no benefit unless the annuitant lives to the annuity starting date is substantially greater than that provided by a contract with a death benefit. John L. Olsen, CLU, ChFC, AEP.

Most taxpayers who purchase longevity annuities do so in order to insure against the risk of outliving their traditional retirement assets. The longevity annuity, therefore, functions as a type of safety net for expenses incurred during advanced age. Where a deferred annuity contract may be more appropriately categorized as an investment product, the primary benefit of a longevity annuity is its insurance value.

483. What is a qualified longevity annuity contract (QLAC)? What steps has the IRS taken to encourage the purchase of QLACs?

A qualified longevity annuity contract (QLAC) is a type of longevity annuity that meets certain IRS requirements that have been proposed in order to encourage the purchase of annuity products with retirement account assets.[1] A QLAC is a type of deferred annuity product that is usually purchased before retirement, but for which payouts are delayed until the taxpayer reaches old age.

Practice Point: Some commentators make a distinction between "longevity annuities" in regard to the annuity starting date (ASD)This is because some contracts specify a particular annuity starting date (ASD) such as age 85; others, offer the purchaser a choice of ASDs. The former variety typically provides no pre-ASD death benefit and the latter may.

In the usual case, if an annuity is held in a retirement plan, the value of that annuity is included in determining the amount of the account owner's required minimum distributions.[2] One of the primary benefits of a QLAC is that the IRS' proposed rules allow the value of the QLAC to be excluded from the account value for purposes of calculating RMDs.[3] Because including the value of a QLAC in determining RMDs could result in the taxpayer being forced to begin annuity payouts earlier than anticipated if the value of his or her other retirement accounts has been depleted, the IRS determined that excluding the value from the RMD calculation furthers the purpose of providing taxpayers with predictable retirement income late in life.[4]

The amount that a taxpayer can invest in a QLAC and exclude from the RMD calculation is limited, however, to the lesser of $125,000 (as adjusted for inflation beginning after 2014) or 25 percent of the taxpayer's retirement account value.[5] The final regulations provide that the 25 percent limit is based upon the account value as it exists on the last valuation date before the date upon which premiums for the annuity contract are paid. This value is increased to account for contributions made during the period that begins after the valuation date and ends before the date the premium is paid. The account value is decreased to account for distributions taken from the account during this same period.[6]

To qualify as a QLAC, the annuity contract must also provide that annuity payouts will begin no later than the first day of the month following the month in which the taxpayer reaches age

1. 2012-13 IRB 598.
2. Treas. Reg. §1.401(a)(9)-6, A-12.
3. See IRC Sec. 401(a)(9).
4. 2012-13 IRB 598.
5. 2012-13 IRB 598.
6. Treas. Reg. §1.401(a)(9)-6, A-17(d)(1)(iii).

eighty-five.[1] Variable annuities, indexed annuities and similar products may not qualify as QLACs unless the IRS specifically releases guidance providing otherwise.[2] Further, a QLAC cannot provide for any commutation benefit, cash surrender value or similar benefit.[3]

484. What types of retirement accounts can hold a qualified longevity annuity contract (QLAC)?

A qualified longevity annuity contracts (QLAC, see Q 483) may be held in a qualified defined contribution plan (such as a 401(k) plan), IRC Section 403 plans, traditional IRAs and individual retirement annuities under Section 408, and eligible IRC Section 457 governmental plans.[4]

An annuity purchased under a Roth IRA cannot quality as a QLAC. If a QLAC is purchased under a traditional IRA or qualified plan that is later rolled over or converted to a Roth IRA, the annuity will not be treated as a QLAC after the date of the rollover or conversion.[5] While it is true that an annuity purchase in a Roth IRA cannot qualify as a QLAC, it should not be assumed that a Roth IRA cannot purchase a longevity annuity. The final regulations do not prohibit this.

485. May both QLACs and non-QLAC DIAs be held in a taxpayer's Traditional IRA and will the QLACs get the RMD exemption of the regulations but the non-QLAC DIAs will not?

The regulations answer this question by their focus; they address QLACs only, not IRA-held DIAs that are not QLACs. They take away nothing that was in existence before. Nothing in the regulations prevents a taxpayer from holding a non-QLAC DIA in a Traditional IRA and the method of RMDs has already been established for non-QLAC DIAs. The Actuarial Present Value [APV] (which may be referred to as Fair Market Value [FMV]) is calculated and RMDs attributable to that value must be taken out of another IRA or a commutation liquidation from the DIA contract. After ASD, the income payments from the DIA automatically satisfy the RMD requirement. No separate calculation is required.

486. May an individual purchase a QLAC after the Required Beginning Date (RBD)?

This is answered by implication in the revised Treasury Reg §1.401(a)(9)-6, A-17(c)(v), which states that, for contracts permitting set non-spousal beneficiary designation, "payments are payable to the beneficiary only if the beneficiary was irrevocably designated on or before the later of the date of purchase or the employee's required beginning date". Clearly, an employee (in the case of a qualified plan) or IRA participant may purchase a QLAC after RBD.

1. Treas. Reg. §1.401(a)(9)-6, A-17(a).
2. Treas. Reg. §1.401(a)(9)-6, A-17(a)(7).
3. Treas. Reg. §1.401(a)(9)-6, A-17(a)(4).
4. Treas. Reg. §1.401(a)(9)-6, A-17(b)(2).
5. Treas. Reg. §1.401(a)(9)-6, A-17(d)(3)(ii).

Practice Point: The final regulations do not answer the following three questions:

1. Can a QLAC in a qualified plan be converted to a Traditional IRA?
2. Can a QLAC in a qualified plan be converted to a ROTH IRA?
3. Can a QLAC in a Traditional IRA be converted to a ROTH IRA?

At this point in time, the answer to this question may depend upon the insurers' administrative systems.

487. Are the death benefits under a deferred annuity triggered upon the death of the owner of the annuity, or upon the death of the annuitant?

Whether death benefits (in particular, certain guaranteed death benefits that may increase the contract value for beneficiaries) are triggered upon the death of the owner of an annuity or the annuitant depends upon the terms of the annuity contract. Annuity contracts can provide that death benefits are triggered upon the death of the annuitant ("annuitant-driven contracts"), upon the death of the owner ("owner-driven contracts") or can provide that death benefits will be paid upon the death of the annuitant *or* the owner.

Notably, all deferred annuity contracts issued after January 18, 1985, in order to qualify for the tax benefits granted to an annuity[1], must specify that if the "holder" of a deferred annuity contract dies before the contract enters payout status, the entire interest must be distributed within five years of the holder's death. Typically, the "holder" of the annuity contract is the owner of that contract, though if the annuity owner is a non-natural person (such as a trust or a corporation), the holder of the contract is the primary annuitant under the contract.[2]

Given this dynamic, the annuity may be required to pay out at the death of an owner for tax purposes (an "owner-driven" rule) even though the guaranteed death benefit may separately trigger based on the death of the owner *or the annuitant*. In cases where the owner and annuitant are not the same person, the contract value must become payable upon the death of the owner, and the annuitant's death may triggers an "enhanced" or guaranteed minimum death benefit (if the death benefit is annuitant-driven). In such scenarios, if the owner dies first, the contract value (but not the guaranteed/enhanced death benefit) of the annuity is paid out. In situations where the owner and annuitant are the same individual, this distinction is generally a moot point.

488. Can a taxpayer combine a deferred income annuity with a traditional annuity product?

Yes. Insurance carriers have begun offering optional riders that can be attached to variable annuity products in order to include the benefits of a deferred income annuity within the variable annuity. These deferred income annuities allow the contract owner to withdraw portions of the variable annuity itself in order to fund annuity payouts late into retirement.

1. IRC Sec. 72(s)(1)(B).
2. IRC Sec. 72(s)(6)(A).

Taxpayers must purchase the rider at the time the variable annuity is purchased and can then begin transferring a portion of the variable annuity accumulation into the deferred income component as soon as two years after the contract is purchased. When the taxpayer begins making transfers into the deferred component, he or she must also choose the beginning date for the deferred payments.

The deferral period can be as brief as two years or, in some cases, as long as forty years, giving taxpayers substantial flexibility in designing the product to meet their individual financial needs. Further, taxpayers can choose to transfer as little as around $1,000 at a time or as much as $100,000 to build the deferred income portion more quickly.

The deferred income annuity rider can simplify taxpayers' retirement income planning strategies in several important ways, not the least of which involves the ability to gain the benefits of both variable and deferred income annuities within one single annuity package.

This single-package treatment also allows taxpayers to avoid the situation where they wish to transition their planning strategies to eliminate the investment-type features common to variable annuity products into a product that allows for a definite income stream—a situation that commonly arises around the time when a taxpayer retires.

Without the combination product, the taxpayer would traditionally be required to execute a tax-free exchange of the variable annuity contract for a deferred income annuity. Instead, the deferred income annuity rider allows the taxpayer to systematically transfer funds from the variable portion of the contract into the deferred income portion over time (though lump sum transfers are also permissible).

489. Can a grantor trust own an annuity contract? How is an annuity owned by a grantor trust taxed?

A grantor trust can own an annuity contract, but, in certain circumstances, the "non-natural person rule" of IRC Section 72(u) will cause the denial of the tax-deferral benefits to an annuity owned by a trust. If annuity tax benefits are denied under the non-natural person rule, income on the annuity for any taxable year will be treated as ordinary income received or accrued by the taxpayer for that tax year.[1] However, if a trust owns an annuity contract as the agent for a natural person, Section 72(u) does not apply.[2]

A revocable grantor trust will usually fall within this exception because the grantor (presumably a natural person) and the grantor trust are treated as one "person" for income tax purposes,[3] and moreover because the property is generally held in trust specifically *for* that grantor. More generally, as long as the grantor trust (a non-natural person) owns the annuity contract, and the primary beneficiaries are natural persons, the annuity contract should escape the non-natural

1. IRC Sec. 72(u)(1).
2. IRC Sec. 72(u)(1)(B).
3. See IRC Sec. 671.

person rule of Section 72(u).[1] If significant interests in the trust are held by non-natural persons, however, it is possible that the trust will not qualify as an agent for a natural person.

If the grantor trust is irrevocable, determining whether the trust is exempt from the non-natural person rule becomes more complicated because the grantor of the trust might not retain any right to the trust assets or income. In making the determination whether significant interests in the trust are held by natural or non-natural persons, it is important to determine who will receive the primary economic benefit of the trust assets.[2]

The IRS has ruled privately that annuity contracts owned by an irrevocable grantor trust established by an employer-corporation (a non-natural person) were held for the benefit of natural persons (the employees) because (1) the employee-beneficiaries of the trust would receive all of the trust income and (2) the employer held no future interest in the trust assets.[3] Therefore, even though the actual grantor of the trust was a non-natural person, the annuity contract was able to escape the non-natural person rule because the beneficiaries were natural persons.

Note that immediate annuities are explicitly exempted from the non-natural person rule of IRC Section 72(u).[4]

490. If a grantor trust owns an annuity and the grantor is not the annuitant, whose death triggers annuity payout?

If a grantor trust owns an annuity and the grantor of the trust is not the annuitant, it is not clear whether annuity payouts will be triggered upon the death of the grantor or upon the death of the annuitant. The Code provides that the primary annuitant will be considered the "holder" of the contract if the owner is a non-natural person (e.g., a trust).[5] Therefore, many experts argue that it is the death of the primary annuitant that triggers annuity payout.

Others disagree, and argue that it is the grantor's death that will trigger payout. This is because of the grantor trust rules, which treat the grantor of a trust and the trust itself as one individual for income tax purposes. Because the grantor is the owner of the trust assets for income tax purposes, many experts argue that the grantor should be treated as owner—or "holder"—for purposes of IRC Section 72(s).

At this point, the matter remains unresolved without any clarity or on-point guidance from the IRS.

Planning Point: Given the current ambiguities, in practice whether payouts will be triggered by the death of the grantor or the death of the annuitant will be dictated by the procedures put into place by the particular insurance company that issues the contract. Because of this, it is important that all parties become familiar with the policies of the insurance company when the annuity is purchased. John L. Olsen, CLU, ChFC, AEP.

1. Let. Ruls. 9316018, 9120024.
2. Let. Ruls. 200449011, 200449013, 200449014.
3. Let. Ruls. 9316018, 9322011.
4. IRC Sec. 72(u)(3).
5. IRC Sec. 72(s)(6)(A).

Loss

491. Does the surrender of a deferred annuity contract ever result in a deductible loss?

In general, a loss deduction can be claimed only if the loss is incurred in connection with the taxpayer's trade or business or in a transaction entered into for profit.[1] Fortunately, the purchase of a personal deferred annuity contract is typically considered a transaction entered into for profit. Consequently, if a taxpayer sustains a loss upon surrender of a deferred annuity contract, the taxpayer may claim a deduction for the loss as a loss on an investment (a transaction entered into for profit).

The amount of the loss is determined by subtracting the cash surrender value (i.e., the net proceeds received after all final charges) from the taxpayer's "basis" for the contract. "Basis" is investment in the contract (e.g., premium paid, less any dividends received (Q 441) and the excludable portion of any prior annuity payments). The loss is an ordinary loss, not a capital loss (which means it does not have to be and should not be netted against capital gains).[2]

While a deductible loss from an annuity is an ordinary loss, there has been a great deal of discussion about *where* a taxpayer should claim the loss on Form 1040. Some say that the loss should be treated as a miscellaneous itemized deduction that is not subject to the 2%-of-AGI floor on miscellaneous itemized deductions. Others take a more aggressive approach and say that the loss can be taken on the front of the Form 1040 on the line labeled "Other gains or (losses)" with supporting reporting on Form 4797.

Planning Point: Although the IRS has not issued definitive guidance on the issue, it is notable that since 2009, IRS Publication 575 (Pension and Annuity Income) has stated the IRS position that a loss under a variable annuity is treated as a miscellaneous itemized deduction subject to the 2 percent floor.[3] There is no apparent reason under the IRC and existing guidance as to why such a position by the IRS would not be upheld in court, if challenged, especially since as a standard rule any deduction not explicitly allowed elsewhere under the tax code is intended to be taken as a miscellaneous itemized deduction (and there is no other place in the tax code that affords special benefits to the deduction of losses for a nonqualified annuity).[4]

Notably, if the taxpayer purchased the contract for purely personal reasons, and not for profit, no loss deduction will be allowed. For example, in one case, the taxpayer purchased annuities on the lives of his relatives, naming his wife as the beneficiary of the contracts. Upon his wife's death, the taxpayer obtained consent from each of his relatives (the annuitants) and named himself as the new beneficiary. He later surrendered the contracts at a loss. The court disallowed a loss deduction on the ground that, even though he suffered a loss, the contracts were not bought for profit, but rather to provide financial security for his relatives.[5]

1. IRC Sec. 165.
2. Rev. Rul. 61-201, 1961-2 CB 46; *Cohan v. Comm.*, 39 F.2d 540 (2nd Cir. 1930), *aff'g* 11 BTA 743 (superseded on other grounds).
3. IRS Pub. 575 (2013), p. 22.
4. IRC Sec. 67(b).
5. Early v. Atkinson, 175 F.2d 118 (4th Cir. 1949).

492. Is a deductible loss sustained under a straight life annuity if the annuitant dies before payments received by the annuitant equal the annuitant's cost?

If the annuitant's annuity starting date is after July 1, 1986, a deduction may be taken on the individual's final income tax return for the unrecovered investment in the contract remaining on the date of death.[1] Similarly, a refund beneficiary may deduct any unrecovered investment in the contract that exceeds the refund payment.[2] 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.[3]

If an annuitant's annuity starting date was before July 2, 1986, there is no deductible loss; the view under the law at the time was that the annuitant had received all that the contract required.[4] For example, no loss deduction was allowed where a husband purchased a single premium nonrefundable annuity on the life of his wife and his wife died before his cost had been recovered. The deduction was disallowed on the ground that the transaction was not entered into for profit.[5] Legislatively, the denial of a deductible loss for unrecovered investment at death was viewed as a trade-off for the fact that exclusion ratio non-taxable payments also could continue beyond the point of fully recovering cost basis for contracts before July 2, 1986.

Disposition

Sale or Purchase of a Contract

493. What are the income tax consequences to the owner of an annuity contract if he or she sells the contract?

According to the decided cases, if an annuity is sold, the amount of taxable gain is determined in the same way as on surrender of a contract (Q 512). In other words, gain is determined by subtracting the investment in the contract (gross premiums less dividends to the extent excludable from income and principal payments already received) from the sale price. In addition, the gain retains its character as ordinary income; thus, where deferred annuities were sold shortly before maturity, the gain was held to be ordinary income.[6]

However, the tax treatment of a sale of a deferred annuity for more than the annuity surrender value is not entirely clear. For example, assume an annuity with a $50,000 cost basis and a $75,000 surrender value was sold for $85,000 (perhaps because it provides a contractual interest rate guarantee that is more appealing than current market rates). The $25,000 gain from cost basis to surrender value must be taxed as ordinary income. It is not clear, however, whether the additional $10,000 of gain would be taxed as though it were an "amount not received as an annuity" (i.e., ordinary income treatment), or the sale of the entire annuity contract as though

1. IRC Sec. 72(b)(3)(A).
2. IRC Sec. 72(b)(3)(B).
3. IRC Sec. 72(b)(3)(C).
4. *Industrial Trust Co. v. Broderick*, 94 F.2d 927 (1st Cir. 1938); Rev. Rul. 72-193, 1972-1 CB 58.
5. *White v. U.S.*, 19 AFTR 2d 658 (N.D. Tex. 1966).
6. *First Nat'l Bank of Kansas City v. Comm.*, 309 F.2d 587 (8th Cir. 1962); *Roff v. Comm.*, 304 F.2d 450 (3rd Cir. 1962).

it were a capital asset (i.e., capital gain treatment). Similar favorable treatment has been allowed in the case of the sale of a life insurance policy for more than its cash surrender value.[1]

Where an annuity contract is sold after maturity, the cost basis of the contract (for purpose of computing the seller's gain) must be reduced by the aggregate excludable portions of the annuity payments that have been received. The adjusted cost basis, however, cannot be reduced below zero (for example, where the annuitant has outlived his or her life expectancy and was able to exclude amounts in excess of his or her net premium cost).[2] The taxable gain, that is, cannot be greater than the sale price. Where an annuity contract is sold for less than its cost basis, the seller realizes an ordinary loss (Q 491).

If the contract sold is subject to a nonrecourse loan, the transferor's obligation under the loan is discharged and the amount of the loan is considered an amount received on the transfer.[3]

494. How is the purchaser of an existing immediate annuity contract taxed?

If the purchaser receives lifetime proceeds under the contract, the purchaser is taxed in the same way as an original owner would be taxed, but with the following difference: the purchaser's cost basis is the consideration the purchaser paid for the contract, plus any premiums the purchaser paid after the purchase and less any excludable dividends and unrepaid excludable loans received by the purchaser after the purchase.

If the contract is purchased after payments commence under a life income or installment option, a new exclusion ratio must be determined, based on the purchaser's cost and expected return computed as of the purchaser's annuity starting date. The purchaser's annuity starting date is the beginning of the first period for which the purchaser receives an annuity payment under the contract (Q 450 to Q 459).[4]

If the purchaser of an annuity is a corporation, or other non-natural person, see Q 439.

Policy Exchanges

495. When is a policy owner deemed to have exchanged one annuity contract for another?

Under IRC Section 1035, policy owners may exchange one nonqualified annuity contract for another on a tax-deferred basis (in the case of qualified annuities, the retirement account rollover rules control the transfer of account balances and their tax consequences).

However, the distinction between an "exchange" and a surrender-and-purchase is not always clear. Where the contract is assignable, the IRS has required a direct transfer of funds between insurance companies.[5] [6] Given that most commercial nonqualified annuities in today's

1. Rev. Ruling 2009-13
2. Treas. Reg. §1.1021-1.
3. Treas. Reg. §1.1001-2(a).
4. Treas. Regs. §§1.72-4(b)(2), 1.72-10(a).
5. See Let. Rul. 8741052. Compare Let. Ruls. 8515063 and 8310033.
6. Rev. Rul. 72-358, 1972-2 CB 473.

marketplace are assignable, the direct-transfer-of-funds method is the standard for completing a 1035 exchange in most common situations.

Nonetheless, the "exchange" of an annuity contract received as part of a distribution from a terminated profit-sharing plan for another annuity with similar restrictions as to transferability, spousal consent, minimum distribution, and the incidental benefit rule was granted IRC Section 1035 treatment.[1] In addition, the IRS has ruled privately that the surrender of a non-assignable annuity contract distributed by a pension trust and immediate endorsement of the check by the annuitant to the new insurer in a single integrated transaction under a binding exchange agreement with the new insurer qualified as an exchange.[2]

On the other hand, while the Tax Court did once allow an exchange where the taxpayer surrendered an annuity contract for cash and then purchased another annuity contract, the IRS acquiesced only in the result of that case.[3] And the IRS has ruled that a taxpayer's receipt of a check issued by an insurance company will be treated as a distribution (and, thus, not an exchange), even if the check is endorsed to a second insurance company for the purchase of a second annuity.[4]

The IRS also has ruled privately that a valid exchange did not occur where the taxpayer surrendered one life insurance policy and then placed the funds in a second policy purchased one month earlier.[5] In another instance, the IRS viewed several transactions as "steps" in one integrated exchange. The taxpayer purchased an annuity contract and later withdrew an amount equal to the taxpayer's basis from the contract, placing the funds in a single premium life insurance policy. Next, the taxpayer exchanged the annuity for another annuity, treating this part of the transaction as a tax-free exchange under IRC Section 1035. The IRS disagreed, characterizing the events as a single exchange, with the value of the life insurance policy received as taxable boot.[6]

496. What is the tax treatment of a partial 1035 exchange?

The Tax Court, in *Conway v. Commissioner*,[7] held that a 1035 exchange occurred when the taxpayer transferred a portion (but not all) of the funds from one annuity to a second newly-issued annuity. The IRS later ruled that the proper way to allocate investment in the contract when one annuity is "split up" into two annuities is on a pro rata basis based on the cash surrender value of the annuity before and after the partial exchange. For example, if 60 percent of an annuity's cash surrender value is transferred to a new annuity, the investment in the contract of the "new" annuity will be 60 percent of the investment in the contract of the "old" annuity, and the investment in the contract of the "old" annuity will be 40 percent of what it was before the partial exchange.[8]

1. Let. Rul. 9233054.
2. Let. Ruls. 8526038, 8501012, 8344029, and 8343010.
3. *Greene v. Comm.*, 85 TC 1024 (1985), *acq*. 1986-2 CB 1.
4. Rev. Rul. 2007-24, 2007-21 IRB 1282.
5. Let. Rul. 8810010.
6. TAM 8905004. See also Let. Rul. 9141025.
7. 111 TC 350 (1998), *acq*. 1999-2 CB xvi.
8. Rev. Rul. 2003-76, 2003-33 CB 355.

In 2008, the IRS released a revenue procedure concerning certain tax-free partial exchanges of annuity contracts (under Sections 1035 and 72(q)). The revenue procedure applies to the direct transfer of a portion of the cash surrender value of an existing annuity contract for a second annuity contract, regardless of whether the two annuity contracts are issued by the same or different companies.

Under current law, a transfer will be treated as a partial tax-free exchange under Section 1035 under current final rules issued in 2008, as updated by Revenue Procedure 2011-38, as long as the taxpayer does not take any withdrawals from either contract (the old or the new one) within 180 days of the partial exchange. When a partial 1035 exchange is completed, the basis is divided pro rata between the old contract and the new one based on the relative value of the contracts when the split occurred.

If the direct transfer of a portion of an annuity contract for a second annuity contract does not qualify as a tax–free exchange, it will generally be treated as a taxable distribution followed by a payment for the second contract, although the Service reserves the right to conclude differently after applying general tax principles to determine the substance and appropriate treatment of the transfer.

The IRS will not require aggregation of two annuity contracts that are the subject of a tax-free exchange (under Section 1035 and this guidance) even if both contracts were issued by the same insurance company.[1]

The exchange of nontransferable tax sheltered[2] annuity contracts is discussed in Q 3931.

Planning Point: Although the rules under IRC Section 1035 cover a broader array of annuity exchanges, funds in nonqualified annuities are not freely movable. For example, the IRS does not provide guidance on the transfer of a portion of the funds in one annuity to a second existing annuity. It is not certain that such a transaction is covered under Section 1035 and therefore this type of transaction may not receive tax-free treatment. *Fred Burkey, CLU, APA, The Union Central Life Insurance Company*.

497. When is the exchange of one annuity contract for another a nontaxable exchange?

The IRC provides that the following exchanges are nontaxable:

(1) the exchange of a life insurance policy for another life insurance policy, for an endowment or annuity contract, or for a qualified long-term care insurance contract;

(2) the exchange of an endowment contract for an annuity contract, for an endowment contract under which payments will begin no later than payments would have begun under the contract exchanged, or for a qualified long-term care insurance contract;

1. Rev. Proc. 2011-38, 2011-30 IRB, *superseding* Notice 2003-51, 2003-33 CB 361.
2. IRC Section 403(b).

(3) the exchange of an annuity contract for another annuity contract; and

(4) the exchange of a long-term care insurance contract for another qualified long-term care insurance contract.[1]

These rules do not apply to any exchange having the effect of transferring property to any non-United States person.[2]

As a result of the Pension Protection Act of 2006, for exchanges after 2009, life, annuity, endowment, and qualified long-term care insurance contracts may now be exchanged for (another) qualified long-term care insurance contract.[3] In addition, the presence of a qualified long-term care insurance contract as a rider on an annuity or life insurance policy does not cause it to fail to qualify for the purposes of such exchanges; in other words, a taxpayer can exchange an annuity without a long-term care insurance contract rider for an annuity with such a rider, and still qualify for nonrecognition treatment.[4]

If an annuity is exchanged for another annuity, the contracts must be payable to the same person or persons. Otherwise, the exchange does not qualify as a tax-free exchange under IRC Section 1035(a).[5] The IRC defines an annuity for this purpose as a contract with an insurance company that may be payable during the life of the annuitant only in installments.[6] Despite the singular reference in IRC Section 1035(a)(3) to "an annuity contract for an annuity contract," the IRS concluded that one annuity could properly be exchanged under IRC Section 1035 for two annuities, issued by either the same or a different insurance company.[7]

Further, the exchange of two life insurance policies for a single annuity contract also has been considered a proper IRC Section 1035 exchange.[8] The exchange of one annuity for a second annuity with a term life insurance rider attached was afforded income tax-free treatment under IRC Section 1035.[9] A proper IRC Section 1035 exchange also occurred where an annuity holder directly transferred a portion of the funds in one annuity to a second newly-issued annuity.[10] An assignment of an annuity contract for consolidation with a pre-existing annuity contract is a tax-free exchange under Section 1035, even though the two annuities were issued by different insurance companies.[11]

The exchange of a life insurance policy, endowment contract, or fixed annuity contract for a variable annuity contract with the same company or a different company qualifies as a tax-free exchange under IRC Section 1035(a).[12] (Although the exchange of a variable annuity for a fixed

1. IRC Sec. 1035(a).
2. IRC Sec. 1035(c).
3. IRC Sec. 1035(a).
4. IRC Sec. 1035(b)(2), IRC Sec. 105(b)(3).
5. Treas. Reg. §1.1035-1.
6. IRC Sec. 1035(b)(2).
7. Let. Rul. 199937042.
8. Let. Rul. 9708016.
9. Let. Rul. 200022003.
10. *Conway v. Comm.*, 111 TC 350 (1998), *acq.* 1999-2 CB xvi.
11. Rev. Rul. 2002-75, 2002-2 CB 812.
12. Rev. Rul. 72-358, 1972-2 CB 473.

annuity is not specifically addressed in this ruling, there does not appear to be any evidence that would prohibit such an exchange from qualifying for IRC Section 1035 treatment, and in practice insurance companies routinely allow this treatment). Additionally, the exchange of an annuity contract issued by a domestic insurer for an annuity contract issued by a foreign insurer was considered a permissible IRC Section 1035 exchange.[1]

498. Is the exchange of one annuity contract for another permissible if the owner-beneficiary inherited the annuity from a deceased original owner?

In general, the original owner of a nonqualified annuity product is able to exchange one annuity for another in an IRC Section 1035 exchange without treating the transaction as a sale—no gain is recognized when the first annuity contract is disposed of, and there is no intervening tax liability. Despite this, Section 1035 requires that, for the annuity exchange to be tax-free, the newly acquired annuity must be payable to the same individual that was entitled to annuity payouts under the original annuity.[2]

The IRS has ruled privately that the beneficiary who inherits rights to payouts under an annuity also inherits an ownership interest in the annuity that is sufficient to allow tax-free exchange treatment under IRC Section 1035.[3]

In the IRS ruling, the beneficiary inherited multiple annuity products and elected to receive distributions over her life expectancy after the original account owner's death. Later, she found an annuity product that offered more attractive investment features and sought to exchange the original contracts for an annuity that would increase her annuity payout, but would continue to distribute those payouts over her life expectancy.

By allowing this exchange, the IRS permitted the beneficiary to exchange the entire pre-tax value of the inherited annuity, rather than requiring that she take a lump sum distribution of the inherited annuity interest, pay taxes on this distribution and then purchase the replacement annuity contract with the after-tax value.

However, the IRS was careful to note that the rules applicable to post-death distributions still apply, meaning that the newly acquired annuity must require distribution of the entire interest in the inherited annuity within five years or over the beneficiary's life expectancy.

Planning Point: Unfortunately, given that the Private Letter Ruling allowing post-death 1035 exchanges was just that – a Private Letter Ruling – insurance companies are not bound and required to honor it. In practice, as with many PLRs pertaining to annuity companies, some have acquiesced, while others have not. As a result, *for situations where a beneficiary is interested in completing an inherited annuity post-death 1035 exchange*, it may be necessary to seek out companies that are specifically willing to cooperate with the assignment of contract necessary to facilitate the exchange. In addition, the original annuity must be liquid enough at death – i.e., not have certain required payout provisions – to allow it to be liquidated and transferred pursuant to a (post-death) 1035 exchange in the first place. Michael E. Kitces, MSFS, MTAX, CFP, CLU, ChFC.

1. Let. Rul. 9319024.
2. IRC Sec. 1035.
3. Let. Rul. 201330016.

499. Are there special rules for exchanging one annuity contract for another where the insurer issuing the contract is under rehabilitation?

The IRS will allow a valid exchange where funds come into the contract or policy in a series of transactions if the insurer issuing the contract or policy to be exchanged is subject to a "rehabilitation, conservatorship, or similar state proceeding."[1]

Funds may be transferred in this "serial" manner if:

(1) the old policy or contract is issued by an insurer subject to a "rehabilitation, conservatorship, insolvency, or similar state proceeding" at the time of the cash distribution;

(2) the policy owner withdraws the full amount of the cash distribution to which he or she is entitled under the terms of the state proceeding;

(3) the exchange would otherwise qualify for IRC Section 1035 treatment; and

(4) the policy owner transfers the funds received from the old contract to a single new contract issued by another insurer not later than 60 days after receipt.

If the amount transferred is not the full amount to which the policy owner ultimately is entitled, the policy owner must assign his or her right to any subsequent distributions to the issuer of the new contract for investment in that contract.[2] If a nonqualified annuity contract is exchanged under IRC Section 1035 within the scope of Revenue Ruling 92-43 (i.e., as part of a rehabilitation proceeding), the annuity received will retain the attributes of the annuity for which it was exchanged for purposes of determining when amounts are to be considered invested and for computing the taxability of any withdrawals (Q 441).[3]

500. When is a policy owner required to recognize gain on the exchange of one annuity contract for another?

If no cash or other non-like kind property is received in connection with an exchange, any gain from the contract surrendered will not be recognized in the transfer to the new contract. Accordingly, the cost basis of the new policy will be the same as the cost basis of the old policy (plus any premiums paid and less any excludable dividends received after the exchange).

If cash or other non-like kind property is received in connection with any of the above exchanges, gain will be recognized to the extent of the cash or other property received as so-called "boot" property.[4] The amount of any policy loan that the other party to the exchange takes property subject to or assumes (reduced by any loan taken subject to or assumed by the first party) is treated as money received on the exchange.[5] If the owner has exchanged an annuity at

1. Rev. Rul. 92-43, 1992-1 CB 288.
2. Rev. Proc. 92-44, 1992-1 CB 875, *as modified* by Rev. Proc. 92-44A, 1992-1 CB 876.
3. Let. Rul. 9442030.
4. Treas. Reg. §1.1031(b)-1(a).
5. Treas. Reg. §1.1031(b)-1(c).

a loss, and the requirements of Section 1035 were satisfied, the receipt of boot does not cause the loss to be recognized.[1]

It should be noted that application of Section 1035 is not an election; its nonrecognition treatment is mandatory when the provisions of that section are met.

501. When is the exchange of one annuity contract for another a taxable transaction?

If the exchange of one annuity contract for another does not qualify for tax-free treatment (see Q 495 to Q 500), it is taxable. For example, if a policyholder exchanges an endowment or annuity contract for a whole life policy, gain will be fully taxable to the policyholder in the year of exchange (since life insurance death proceeds are exempt from tax, the government views any exchange that provides life insurance protection where none existed as a method of tax avoidance). The gain is ordinary income – not capital gain.[2]

The amount of taxable gain is determined by subtracting (1) the net premium cost (gross premiums less any excludable dividends) from (2) the value of the new policy plus any cash or the fair market value of any other property received in the exchange (in most cases, this will simply be the gain that was embedded in the original contract). The value of the new policy, for this purpose, is not cash surrender value but fair market value (i.e., the value that came into the contract before the potential application of any new surrender charges). Thus, if the new policy is single-premium or paid-up, its value is its replacement cost (the price that a person of the same age and sex as the insured would have to pay for a similar policy with the same company on the date of exchange).[3] If the new policy is premium-paying, apparently its value is its interpolated terminal reserve plus any unearned premium as of the date of exchange (see Q 139).[4]

An exchange where both contracts or policies are issued by the same insurer (i.e., an "in-house" exchange) is not subject to the reporting requirements for IRC Section 1035 exchanges[5] provided that the exchange does not result in a designated distribution and the insurer's records are sufficient to determine the policyholder's basis.[6]

The effect of a tax-free exchange of annuity contracts on taxation of amounts received under the replacing contract is discussed in Q 441 and Q 517.

502. What is the tax treatment for an annuity with a long-term care rider?

Under the Pension Protection Act, annuities issued after December 31, 2009 may include a qualified long-term care insurance rider. Under these rules, inclusion of the rider will not trigger taxable distributions as premiums are deducted from cash value for long-term care

1. IRC Secs. 1035(d)(1), 1031(c).
2. Treas. Reg. §1.1035-1; Rev. Rul. 54-264, 1954-2 CB 57; *Barrett v. Comm.*, 16 AFTR2d 5380 (1st Cir. 1965) *aff'g* 42 TC 993.
3. *Parsons v. Comm.*, 16 TC 256 (1951); *Barrett*, supra; Rev. Rul. 54-264, supra.
4. Rev. Rul. 59-195, 1959-1 CB 18.
5. IRC Sec. 6047(d).
6. Rev. Proc. 92-26, 1992-1 CB 744.

premiums, although such charges will reduce investment in the contract.[1] In addition, all long-term care benefits paid under the rider (whether attributable to gains or cost basis) will be tax-free and are excludable from the recipient's gross income (and not reduce investment in the contract).

In order to qualify for favorable treatment, the long-term care insurance policy must conform to the "qualified" long-term care insurance requirements of IRC Section 7702B. In a private letter ruling, the IRS analyzed the federal income tax treatment of a particular company's long-term care insurance rider to be offered with certain annuity contracts by an insurance company with respect to taxable years beginning after December 31, 2009, and ruled that the rider will constitute a qualified long-term care insurance contract.[2]

Gift of an Annuity or Endowment Contract

503. What constitutes a gift of an annuity contract? What constitutes a gift of a premium?

A person has made a gift of the contract if the person (1) purchases an annuity contract, the proceeds of which are payable to a beneficiary other than the person or the person's estate, (2) retains no reversionary interest in the estate, and (3) has no power to re-vest the economic benefits in himself or herself or the estate, or to change the beneficiary. Likewise, if a person fully transfers (absolutely assigns) a contract, or relinquishes by assignment every power the person retained in a previously issued contract, the person has made a gift. If the person pays a premium on a contract and has no ownership rights, the person has made a gift of the premium. Of course, if the person receives adequate consideration for the transfer, it is not a gift.[3]

For the income tax consequences when the owner makes a gift of an annuity contract, see Q 505.

The Tax Court held that a donor's assignment of life insurance benefits and payment of annual premiums constituted a gift of the benefits from the insured to his children as of the date that the donor renounced his right to change beneficiaries, where the donor did not retain the power to revest the benefits in himself.[4] In another case, a divorced wife owned insurance policies on the life of her former husband. Pursuant to the terms of a property settlement calling for the insured to pay future premiums and any gift tax, the former wife assigned the policies to the parties' children. The court held that the transfer of life insurance policies was an indirect gift of the policies from the insured to the children.[5]

See Q 111 regarding gifts with respect to split dollar arrangements.

The IRS has ruled that where (1) an employee has irrevocably assigned the employee's rights under a group term life policy, (2) the policy is later replaced by a policy identical in all material

1. IRC Section 72(e)(11); IRS Notice 2011-68.
2. IRC Secs. 72, 104, 7702B.
3. Treas. Reg. §25.2511-1(h)(8).
4. *Fletcher Trust Co. v. Comm.*, 1 TC 798 (1943), *aff'd*, 141 F.2d 36 (7th Cir. 1944).
5. *duPont v. Comm.*, TC Memo 1978-16.

respects to the prior policy, and (3) the new policy provides that an employee's irrevocable assignment of the employee's rights under the old policy is effective to vest in the assignee the insured's rights under the new policy, the replacement of the old policy with the new does not constitute a new gift of policy rights for federal gift tax purposes.[1]

504. Can the owner of an annuity contract avoid income and penalty taxes by assigning the right to receive the payments to another individual while retaining ownership of the contract?

No.

It is a basic tax principle that "fruit" is attributed to the "tree" on which it grows.

Without actually transferring the underlying contract, a gift or gratuitous assignment of just the income will not shift the taxability of the income away from the owner of the contract. This applies to income accumulated on the contract before or after the assignment. [2] Thus, withdrawals and annuity payments are taxable to the owner, even if paid to a third party. It would apparently follow that any liability for a premature distribution penalty would be on the policy owner, and would be based on the owner's age, death, or disability.

Where the owner makes a gift of the underlying contract, see Q 505.

505. What are the income tax consequences when a deferred annuity contract is transferred as a gift?

An individual who transfers a nonqualified deferred annuity contract issued after April 22, 1987, for less than full and adequate consideration is treated as having received "an amount not received as annuity" (Q 441). Thus, the individual transferring the contract realizes in the year of the transfer any gain on the contract (the excess of the cash surrender value over the investment in the contract).[3]

The IRS has ruled privately that the distribution of an annuity contract by a trust to a trust beneficiary will not be treated as an assignment for less than full and adequate consideration because the trust as transferor is not considered an individual.[4] In addition, this rule also does not apply to transfers between spouses (or between former spouses incident to a divorce and pursuant to an instrument executed or modified after July 18, 1984), except that it does apply to a gift of a contract in trust for such a spouse to the extent that gain must be recognized because of any loan to which the contract is subject (Q 101).

In the case of an annuity contract issued prior to April 23, 1987, if the cash surrender value at the time of the gift exceeds the donor's cost basis and the donee subsequently surrenders the contract, the donor must, in the year of the *surrender* (which might not be the year of gift), report as taxable income the "gain" existing at the time of the gift. In other words, the donor

1. Let. Rul. 8230038.
2. *Helvering v. Eubank*, 311 U.S. 112 (1940); *Lucas v. Earl*, 281 U.S. 111 (1930).
3. IRC Sec. 72(e)(4)(C).
4. Let. Ruls. 9204010, 9204014.

is taxed on the difference between the premiums the donor had paid (less any excludable dividends the donor has received) and the cash surrender value of the contract at the time of the gift, but not until the donee surrenders the contract. The balance of the gain, if any, is taxed to the donee. Thus, in the case of a pre-April 23, 1987 contract, the proper year for the donor to include the gain in the donor's gross income is the year in which the contract is surrendered by the donee; with a post-April 22, 1987 annuity, gain is always recognized at the time (in the year) that the transfer occurs.[1]

Subsequent annuity payments under a contract that has been transferred as a gift are taxed under the annuity rules (Q 450 to Q 478). With respect to gifts of annuities issued after April 22, 1987, the amount of gain, if any, that is included in the transferor's income as a result of the transfer will increase the transferee's investment in the contract for the purposes of calculating the exclusion ratio.[2] If the contract was issued before April 23, 1987, all premiums paid and excludable dividends received by both the donor and donee prior to the commencement of the annuity payments are taken into account in determining the investment in the contract. The annuity starting date and expected return are determined as though no transfer has taken place.[3] However, the IRS has not ruled on whether, if the contract was transferred when the cash surrender value exceeded the donor's cost basis, the donor must include any portion of the payments in the donor's gross income or how such portion would be determined.

Where a gift is conditioned on payment by the donee of the donor's gift tax liability, a court has ruled that income is realized by the donor to the extent the gift tax exceeds the donor's basis in the property.[4] The gain is included in the donor's income for the year in which the gift tax is paid by the donee.[5] However, payment of federal or state gift tax by the donee (or agreement to pay such tax) does not result in income to the donor in the case of net gifts made before March 4, 1981.[6]

If the contract transferred is subject to a nonrecourse loan, the transferor's obligation under the loan is discharged and the amount of the loan is treated as an amount received with the result that gain is recognized to the extent the loan exceeds the adjusted basis.[7]

If the gift is to a corporation or other nonnatural person, see Q 439.

506. What are the income tax consequences when a deferred annuity contract is transferred to a trust?

When an annuity is gifted to a revocable living trust, the grantor retains control of the property, such that no "transfer" without adequate consideration has taken place; thus, there are no income tax consequences for such transfers.

1. Rev. Rul. 69-102, 1969-1 CB 32.
2. IRC Sec. 72(e)(4)(C)(iii).
3. Treas. Reg. §1.72-10(b).
4. *Diedrich v. Comm.*, 82-1 USTC ¶9419 (1982).
5. *Weeden v. Comm.*, 82-2 USTC ¶9556 (9th Cir. 1982).
6. TRA '84, Sec. 1026.
7. Treas. Reg. §1.1001-2(a).

The gift of an annuity to the donor's irrevocable grantor trust is more problematic. Many commentators hold that such transfer cannot be subject to tax because transfers from a taxpayer to the taxpayer's grantor trust are not taxable events. The gift of an annuity to one's irrevocable trust, however, may be a completed gift subject to tax. A strict reading of IRC Section 72(e)(4)(C) will conclude that recognition of gain upon the transfer of an annuity occurs whenever such transfer is made without full and adequate consideration. A gift of an annuity to an irrevocable trust (grantor or not) arguably meets that test, especially if the transferor reports the same on a Gift Tax Return; in other words, the Section 72(e)(4)(C) test appears to be based on gift treatment, not income tax treatment, even though it ultimately has income tax consequences. As of the spring of 2014, the IRS has not provided definitive guidance on this point.

507. Does the purchase of a joint and survivor annuity result in a taxable gift?

Yes, if the purchaser of the contract does not reserve the right to change the beneficiary of the survivor payments.[1]

Planning Point: In the case of a joint and survivor annuity between spouses, the unlimited marital deduction makes this a moot point (see Q 509); in the case of a non-spouse joint annuitant, though, gift tax consequences may be incurred.

On how to value the gift, see Q 510.

508. Is the naming of an irrevocable beneficiary under a refund annuity a gift?

Yes.

This is true even though the beneficiary will get nothing unless the annuitant dies before receiving payments equal to the annuitant's premium cost. Because the gift is contingent on the annuitant's death within a specified period, it is the gift of a "future interest" and therefore does not qualify for the annual exclusion (Q 213).[2] The value of the gift is the present value of the contingent right to receive any remaining refund payments upon the death of the annuitant.

Where the gift is from one spouse to another, see Q 541.

509. When does the gift of an annuity between spouses qualify for the gift tax marital deduction?

A direct gift to a spouse of an annuity contract in which no one else has an interest qualifies for the gift tax marital deduction. The interest of a donee spouse in a joint and survivor annuity in which only the donor and donee spouses have a right to receive payments during such spouses' joint lifetimes is treated as a "qualifying income interest for life" for which the marital deduction is available unless the donor spouse irrevocably elects otherwise within the time allowed for filing a gift tax return.[3]

1. IRC Sec. 2523(f)(6).
2. *Morrow v. Comm.*, 2 TC 210 (1943).
3. IRC Sec. 2523(f)(6).

To the extent provided in the IRS regulations, an annuity interest is treated in a manner similar to an income interest in property (regardless of whether the property from which the annuity is payable can be separately identified).[1] If, however, an election is made to not have the donee spouse's interest treated as a "qualifying income interest for life," the marital deduction is not allowed if the donor gives an interest in the contract to a third party, or keeps an interest for himself, and there is a possibility that the donor or the third party could receive some benefits from this interest after the donee's interest ends.

Thus, if the donee spouse's interest is not treated as a "qualifying income interest for life," the gift of a refund annuity will not qualify if the refund is payable to the donor or a third party in the event of the donee's death during the refund period.[2]

Although the gift tax marital deduction is not allowed for a non-US citizen spouse, an annual exclusion may be allowed instead of the marital deduction.[3] For calendar year 2014, the exclusion is increased to $145,000 (up from $143,000 in 2013). However, this rule does not apply for gifts of future interests of property, which includes transfers resulting from joint and survivor annuities.[4]

510. What is the gift tax value of an annuity contract or of a donee's interest in a joint and survivor annuity?

Where an annuity is purchased by a donor on his or her own life and immediately given to another, or when an annuity is purchased by one person for another on the latter's life, the value of the gift is the premium paid for the contract.[5] If a person purchases an annuity and gives the contract to another person at a later date after the annuity starting date (i.e., once annuity payments have begun), the gift tax value is the single premium the company would charge for an annuity providing payments of the same amount on the life of a person who is the annuitant's age at the time of the gift.[6] The value of a deferred premium-paying annuity is the terminal reserve, adjusted to the date of the gift, plus the unearned portion of the last premium payment (Q 114).[7]

Joint and Survivor Annuity

Where a donor purchases a joint and survivor annuity for the benefit of the donor and another, the gift tax value is the cost of the annuity less the cost of a single life annuity for the donor.[8]

> *Example*: A donor purchases from a life insurance company for $15,198 a joint and survivor annuity contract that provides for the payment of $60 a month to the donor during the donor's lifetime, and then to the donor's sibling for such time as the sibling may survive the donor. The premium that would have been

1. IRC Sec. 2523(f)(3).
2. Treas. Reg. §25.2523(b)-1(b)(6)(Example 3); §25.2523(b)-1(c)(2).
3. IRC Sec. 2523(i).
4. Rev. Proc. 2012-41, 2012-45 IRB 539, Rev. Proc. 2013-35, 2013-47 IRB 537.
5. Treas. Reg. §25.2512-6(a) (Ex.1).
6. Treas. Reg. §25.2512-6(a) (Ex. 2).
7. *Comm. v. Edwards*, 135 F.2d 574 (5th Cir. 1942).
8. Treas. Reg. §25.2512-6(a).

charged by the company for an annuity of $60 monthly payable during the life of the donor alone is $10,690. The value of the gift is $4,508 ($15,198 less $10,690).[1]

511. Can the purchase of a private annuity result in a taxable gift?

There is no gift if the purchase of an annuity is a bona fide ordinary business transaction.[2]

Where closely related parties are involved, however, a gift is made to the promisor of the amount by which the fair market value of the property exchanged for the annuity exceeds the present value of the annuity.[3] Likewise, a gift can be deemed made to the purchaser of the amount by which the present value of the annuity exceeds the fair market value of the property transferred. There will be no gift even in an intra-family transaction, however, if substantially equal values are exchanged and there is no donative intent found.[4]

Before May 1, 2009, the present value of the annuity generally was determined by use of the current estate and gift tax valuation tables (Q 764).[5] After May 1, 2009, the present value is determined under Section 7520's actuarial factors.[6]

Surrender, Redemption, or Maturity

512. What are the income tax consequences when the owner of an annuity contract takes the lifetime maturity proceeds or cash surrender value in a lump sum cash payment?

Amounts received on complete surrender, redemption, or maturity are taxable to the extent that the maturity proceeds or cash surrender value exceed the investment in the contract. (Q 10, Q 441).[7] The excess is taxable income in the year of maturity or surrender, even if the proceeds are not received until a later tax year.[8]

The investment in the contract is the aggregate premiums or other consideration paid for the annuity minus amounts paid out that were excluded from income (and/or any dividends received).[9] The gain is ordinary income, not capital gain, and thus cannot be netted against capital losses.[10]

Some commentators and some insurers have taken the position that the gain on total surrender of a deferred annuity equals the cash value prior to surrender, without regard to surrender charges[11] less taxpayer's investment in the contract.

1. Treas. Reg. §25.2512-6(a) (Ex. 5).
2. Rev. Rul. 69-74, 1969-1 CB 43, Treas. Regs. §§25.2511-1(g)(1), 25.2512-8.
3. Rev. Rul. 69-74, above; *Est. of Bell v. Comm.*, 60 TC 469 (1973); *Fehrs v. U.S.*, 79-2 USTC ¶13,324 (Ct. Cl. 1979); *La Fargue v. Comm.*, 800 F.2d 936 (9th Cir. 1986).
4. *Ellis Sarasota Bank & Trust Co. v. U.S.*, 77-2 USTC ¶13,204 (M.D. Fla. 1977). See also Rev. Rul. 76-491, 1976-2 CB 301.
5. Notice 89-60, 1989-1 CB 700; Treas. Regs. §§20.2031-1, 25.2512-1; *Est. of Cullison v. Comm.*, 221 F.3d 1347, 2000-1 USTC ¶60,376 (9th Cir. 2000).
6. Treas. Reg. §25.2512-5(d).
7. IRC Sec. 72(e)(5)(E).
8. *Kappel v. U.S.*, 369 F. Supp. 267, 34 AFTR 2d 5025 (W.D. Pa. 1974).
9. IRC Sec. 72(e)(6).
10. IRC Sec. 72(e); Treas. Reg. §1.72-11(d); *Bodine v. Comm.*, 103 F.2d 982 (3rd Cir. 1939); *Cobbs v. Comm.*, 39 BTA 642 (1939).
11. IRC Sec. 72(e)(3)(A).

Example: John's deferred annuity has a current cash value of $110,000, to which a surrender charge of $10,000 applies. His investment in the contract is $100,000. The position described above holds that if John surrenders the contract now for its net surrender value of $100,000, he will recognize a gain of $10,000 (the cash value of the contract prior to surrender, without regard to surrender charges, less his investment in the contract).

This application of Section 72(e)(3)(A) is incorrect; it applies only in the case of partial surrenders. In the case of a full surrender, IRC Section 72(e)(5) states that in the case of "full refunds, surrenders, redemptions, & maturities,"…"the rule of paragraph 2(A) shall not apply"[1] (for which rule, and only for which rule, the "without regard to surrender charges" condition of Section 72(e)(3)(A) exists).

The correct computation of John's gain in the contract is the surrender value minus the amount actually received by John upon surrender, less investment in the contract ($100,000 – $100,000 = zero gain).[2] However, if John had only taken out a partial withdrawal – e.g., $20,000 – the first $10,000 would be gain and the second $10,000 would be return of return (as with partial surrenders, gain is determined without regard to surrender charges).

513. If a policyholder elects to receive endowment maturity death benefit proceeds, or cash surrender values under a life income or installment option, is the gain on the policy taxable to the policyholder in the year of maturity/death/surrender or as payments are received?

Ordinarily, a cash basis taxpayer is treated as having constructively received an amount of cash when it first becomes available to the taxpayer without substantial limitations or restrictions. The taxpayer must report this amount as taxable income even if he or she has not actually received it.[3]

When an endowment contract matures, a death benefit becomes payable, or when any type of contract is surrendered, a lump sum payment generally becomes available to the policyholder unless, before the maturity or surrender date, the policyholder has elected to postpone receipt of the proceeds under a settlement option.

However, a lump sum will not be considered constructively received in the year of maturity or surrender if, within sixty days after the lump sum becomes available and before receiving any payment in cash, the policyholder exercises an option or agrees with the insurer to take the proceeds as an annuity.[4]

The sixty day extension is allowed only for the election of a life income or other installment-type settlement (those considered annuities (Q 437)). It does not apply to an election to leave the proceeds on deposit at interest; if a taxpayer wishes to make an election to leave proceeds on deposit at interest and still defer taxation, such an election must be made before maturity or surrender (if available under the contract) to avoid constructive receipt (Q 21).

1. IRC Sec. 72(e)(5)(E).
2. See Let. Rul. 200030013.
3. Treas. Reg. §1.451-2.
4. IRC Sec. 72(h); Treas. Reg. §1.72-12.

If there is a gain on the contract but the proceeds are not constructively received and instead are received as a life income or installment-type settlement as an annuity, the policyholder is not taxed on the gain in the year of maturity or surrender. Instead, the amounts are taxed as "amounts received as an annuity" when payments are made, under the standard rules applicable to such payments.

If there is a gain on the contract and the proceeds *are* constructively received (as where the election is made after the sixty day period), the full gain is taxable to the policyholder in the year of constructive receipt as if he or she actually had received a one sum cash payment (Q 51). Because gain *has* been recognized, if the contract is subsequently annuitized the investment in the contract (cost) would not be premium cost but would be the entire lump sum applied under the settlement option (as though the contract had simply been surrendered with the proceeds reinvested into a new contract as a separate transaction). Although the larger cost would result in a larger excludable portion for the annuity payments, it usually is advisable for the policyholder to avoid being taxed on the entire gain in one year in the first place.

Even where the cash surrender value is less than net premium cost, it appears that net premiums may be used as "cost" in determining the exclusion ratio for the annuity payments, provided the cash surrender value is not constructively received in the year of surrender.[1]

514. Is the full gain on a deferred annuity or retirement income contract taxable in the year the contract matures?

If the contract provides for automatic settlement under an annuity option, the lump sum proceeds are not constructively received in the year of maturity; if the policy provides a choice of settlement options, the policy owner can opt out of the lump sum proceeds choice within 60 days and avoid constructive receipt (Q 513).[2] The annuity payments (whether life income or installment) are taxed under the regular annuity rules (Q 450 to Q 478) as they are received in the future. In computing the exclusion ratio for the payments, the amount to be used as the investment in the contract is premium cost, not the maturity value (Q 456).

Of course, if the contract owner takes a lump sum settlement at maturity, the contract owner must include the gain in gross income for the year in which he or she receives the payment (Q 512).

For election to leave life insurance proceeds on deposit at interest, see Q 21.

If the deferred annuity contract is owned by a person other than a natural person, such as a corporation, see Q 439.

515. Are there any considerations that a taxpayer should be made aware of when deciding whether to surrender an annuity or accept a buyback offer?

Taxpayers who purchased variable annuities with a view toward generating retirement income may be facing buyout offers from an issuing insurance company, notices that their investment

1. IRC Sec. 72(c)(1); Treas. Reg. §1.72-6(a)(1).
2. IRC Sec. 72(h); Treas. Reg. §1.72-12.

choices are being limited to those that are very conservative, or may simply find themselves facing changed circumstances so that the product no longer makes sense.

For example, a taxpayer who has recently been diagnosed with a disease that is likely to shorten his or her life expectancy may find that surrendering the annuity in exchange for a lump sum payout may better serve his or her reduced need for lifetime income. Other taxpayers may be facing unanticipated expenses and see the buyout as a way to meet those expenses.

Taxpayers facing the need for an immediate lump sum of cash should also be aware that it may be possible for them to withdraw a portion of the annuity's assets, keeping only a small part of the initial investment in the annuity to maintain the contract's death benefit. Taxpayers who are simply unhappy with the variable annuity's investment performance may also find this strategy appealing, as they can then invest in another income-producing product while preserving some value in the original annuity.

For taxpayers who are still attracted to the income-producing feature of a variable annuity, however, it might be best to hold on to the product in the face of a buyout offer, especially if the product offers guaranteed returns that may be unavailable in a replacement product.

After a taxpayer has determined that his or her best interests will be served by surrendering the product, the surrender charges associated with the annuity still must be taken into account. If the taxpayer has a buyout offer on the table, it is likely that the insurance company has already offered to waive any surrender charges. If the taxpayer has independently decided to surrender, however, he or she may be able to negotiate a waiver, especially if the taxpayer agrees to reinvest the recovered annuity funds with the same carrier that issued the surrendered product.

It is important that taxpayers realize they will owe taxes upon any gain realized at the time of surrender. If the taxpayer has only held the annuity product for a few years, this gain might not be substantial—in fact, many variable annuity products that were issued just before the economic downturn in 2008 are just now returning owners to the break-even point. Still, for taxpayers who have owned the variable annuity for many years, the tax liability can be substantial—especially when the new 3.8 percent investment income tax for high earning taxpayers (see Q 8577 to Q 8604) is taken into account.

For taxpayers who purchased the annuity product within an IRA, the funds can be transferred in a trustee-to-trustee type rollover transaction, which allows the taxpayer to defer taxation until the funds are withdrawn from the IRA. Taxation can also be deferred if the taxpayer exchanges the undesirable annuity for another annuity product in a tax-free exchange under IRC Section 1035.

Death

516. If an annuitant dies before his or her deferred annuity matures or is annuitized, is the amount payable at the annuitant's death subject to income tax?

Yes, to the extent there are any gains.

An annuity contract generally provides that if the annuitant dies before the annuity starting date, the beneficiary will be paid, as a death benefit, the greater of the amount of premiums paid or the accumulated value of the contract (although some contracts may provide additional "enhanced" death benefits as well).

The gain, if any, is taxable as ordinary income to the beneficiary, and is measured by subtracting (1) investment in the contract (reduced by aggregate dividends and any other amounts that have been received under the contract that were excludable from gross income) from (2) the death benefit, including any enhancements (Q 441).[1] The gains are taxable when received, and are taxable to the beneficiary that receives the payments (not the decedent). Thus, annuities do *not* receive a step-up in basis at death (except for certain pre-October 21 1979 grandfathered annuities; see later in this section for further discussion).

The death benefit under an annuity contract does not qualify for tax exemption under IRC Section 101(a) as life insurance proceeds payable by reason of the insured's death. Instead, death benefits paid on the death of the owner or the annuitant is income-in-respect-of-a-decedent ("IRD") to the extent that the death benefit amount exceeds the basis in the annuity contract; as a result, the beneficiary may be eligible for a special income tax deduction for any Federal estate taxes paid that were attributable to the IRD.[2] The IRS has ruled that an assignment of an annuity from a decedent's estate to a charity will not cause the estate or its beneficiaries to be taxed on the proceeds of the annuity.[3]

Planning Point: The owner of a nonqualified deferred annuity generally should be named as the annuitant. Where the owner and annuitant are two different individuals, problems can result, especially if the annuity is annuitant-driven. (All annuities issued since 1986 are "owner driven" where a requirement to pay out the cash value is triggered by the death of the owner. Some also are annuitant-driven, where the death benefit is triggered by the death of the annuitant. Some annuitant-driven deferred annuities provide for two death benefits: the guaranteed minimum death benefit, which may exceed the annuity cash value, that is payable upon death of the annuitant, and the cash value itself, which must be paid out on the death of the owner.) If the owner and annuitant are the same person, none of this matters; if they are not, it does. *John L. Olsen, CLU, ChFC, AEP, Olsen Financial Group.*

In the case of a deferred annuity that provides the beneficiary with the option to take the death benefit as a lump sum, the beneficiary will not be taxed on the gain in the year of death if he or she elects "within 60 days after the day of which such lump sum first became payable" to apply the death benefit under a life income or installment option (Q 513).[4] The periodic payments then will be taxable to the beneficiary under the regular annuity rules (Q 450 to Q 470). The exclusion ratio for the contract will be based on the decedent's investment in the contract and the beneficiary's expected return.[5]

What is the meaning of "within sixty days after the day of which such lump sum first became payable"? Some commentators argue that this means within sixty days of the death that triggered such lump sum (i.e., the death of the annuity owner, in all cases, or, in the case

1. IRC Sec. 72(e)(5)(E); Treas. Reg. §1.72-11(c).
2. Rev. Rul. 2005-30, 2005-20 IRB 1015.
3. Let. Rul. 200618023.
4. IRC Sec. 72(h).
5. Treas. Regs. §§1.72-11(a), 1.72-11(e).

of an "annuitant-driven" annuity, the death of the annuitant). It may be argued, however, that no such lump sum becomes payable until the beneficiary submits proof of such death, together with a claim for the death benefit, to the insurer. Treasury Regulation Section 1.451-2(a) states that "income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions." A beneficiary cannot receive payment of a death benefit before it is paid, and an insurer will not make such payment until it receives proof of death and properly completed claim forms. Treasury has provided no definitive guidance on this issue of when exactly the 60-day period begins, beyond noting that a "timely election" under Section 72(h) is required.

There is a widespread (mis-)belief that the beneficiary of a deferred annuity, where the owner died prior to annuity starting date, has one year, not sixty days, in which to make an election to take the death proceeds as an annuity without becoming in constructive receipt of all contract gain. This mis-belief is grounded in the fact that IRC Section 72(s)(2) provides that no contract issued since January 18, 1985 shall be considered "an annuity" (and taxed as an annuity) unless it provides that "any portion of the holder's interest" that is payable to a designated beneficiary will be distributed "over the life of such designated beneficiary (or over a period not extending beyond the life expectancy of such beneficiary)," and that "such distributions begin not later than 1 year after the date of the holder's death or such later date as the Secretary may by regulations prescribe" (Q 517). That provision, however, states only the provisions that an annuity contract must contain (with respect to distributions made on the death of any holder) to be deemed "an annuity" for tax purposes. It does not speak to how long a beneficiary may wait to exercise an annuity payout option without being in constructive receipt of all contract gain; as noted above, IRC Section 72(h) does speak to this. Moreover, Section 72(s) applies only on the death of the holder of an annuity and not when the annuitant of an annuitant-driven contract dies. Some commentators suggest that Section 72(s) "trumps" Section 72(h) because it is newer. The latter section, however, has not been repealed or amended.

The rules described above apply to non-variable annuity contracts as well as to variable annuity contracts purchased after October 20, 1979, and to contributions made after October 20, 1979, to variable annuities issued prior to this date. If the owner of a variable annuity contract acquired prior to October 21, 1979, including any contributions applied to such an annuity contract pursuant to a binding commitment entered into before that date, dies prior to the annuity starting date, the contract acquires a new "step-up" cost basis. The basis of the contract in the hands of the beneficiary will be the value of the contract 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 appreciation in the value of the contract while owned by the decedent will escape income tax entirely.[1] However, where a variable annuity contract purchased before October 21, 1979 had been exchanged for another variable annuity contract under IRC Section 1035 after October 20, 1979, and the annuity owner died prior to the annuity starting date, the beneficiary was not entitled to a step-up in basis.[2] Although the aforementioned step-up in basis treatment for pre-October 21, 1979 annuities has only been directly ruled on

1. Rev. Rul. 79-335, 1979-2 CB 292
2. TAM 9346002; Let. Rul. 9245035.

in the case of a variable annuity, it also would theoretically apply to fixed annuities issued prior to October 21, 1979.

Normally the death benefit is payable at death. If it is not payable until a later time and the annuitant also was the owner of the annuity contract, see Q 517.

517. What distributions are required when the owner of an annuity contract dies before the entire interest in the contract has been distributed?

A deferred annuity contract issued after January 18, 1985, will not be treated as an "annuity contract" and taxed under the favorable provisions of IRC Section 72 unless it provides that if any owner dies –

- on or after the annuity starting date (in other words, when the annuity was in "payout status") and before the entire interest in the contract has been distributed, the remaining portion will be distributed at least "as rapidly as under the method of distribution being used as of the date of the owner's death," and[1]
- before the annuity starting date, the entire interest in the contract will be distributed within five years after the owner's death,[2] unless either of two exceptions applies allowing for a stretch over a beneficiary's life expectancy or a continuation in the name of the surviving spouse (see Q 518).

In the case of joint owners of a contract issued after April 22, 1987, these distribution requirements are applied at the *first* death, not the second death.

Effect of Exchange on Pre-January 19, 1985 Contracts

According to the report of the conference committee (TRA '84), an annuity contract issued after January 18, 1985 in exchange for one issued earlier will be considered a new contract and will be subject to the distribution requirements.[3]

518. Are there any exceptions to the rule that the entire interest in an inherited deferred annuity contract must be distributed within five years of the original owner's death?

Installment payments made to a designated beneficiary. If any portion of the owner's interest is to be distributed to a *designated beneficiary* (see definition later in this section) over the life of such beneficiary (or over a period not extending beyond the life expectancy of the beneficiary) and such distributions begin within one year after the owner's death, the five-year requirement does not apply.[4]

Where the beneficiary is the surviving spouse of the annuity owner. If a designated beneficiary is the surviving spouse of the "holder of the contract" (the owner), that person may treat the

1. IRC Sec. 72(s)(1)(A).
2. IRC Sec. 72(s)(1)(B).
3. H.R. Conf. Rep. No. 98-861 (TRA '84) reprinted in 1984-3 CB Vol. 2 331-332.
4. IRC Sec. 72(s)(2).

annuity as his or her own (that is, as if he or she had owned it from inception) and continue the contract.[1] This "spousal continuation" option must be allowed in the annuity contract to be exercised. Some contracts require that the surviving spouse be the sole beneficiary to elect this "spousal continuation" option.

Amounts distributed under these requirements are taxed under the general rules applicable to amounts distributed under annuity contracts. These rules are intended to prevent protracted deferral of tax on the gain in the contract through successive ownership of the contract.

Where the owner of a contract issued after April 22, 1987 is a corporation or other non-natural person, the primary annuitant, as designated in the contract, will be treated as the owner of the contract for purposes of the distribution requirements of Section 72(s),[2] and a change in the primary annuitant of such a contract will be treated as the death of the owner.[3] Where the owner is a corporation or other non-natural person, see also Q 439.

These requirements do not apply to annuities purchased to fund periodic payment of damages on account of personal injuries or sickness.[4] Although these requirements do not apply with respect to qualified pension, profit sharing and stock bonus plans, IRC Section 403(b) tax sheltered annuities, and individual retirement annuities, similar distribution requirements do apply (Q 3638, Q 3806, Q 3954).

Where the Beneficiary is Not a Natural Person

The term *designated beneficiary* means an individual – a human being. Where the beneficiary is not a human being, the Section 72(s)(2) and (s)(3) exceptions to the five year payout rule probably are not available. If a trust, for example, is named as beneficiary of a deferred annuity, and the annuity owner (or primary annuitant, as deemed owner, if the trust owns the annuity) dies, the trust probably will be unable to take distributions other than in a lump sum or within five years. This is because most insurers take the position that a trust, as a non-natural person, is not an individual, cannot be a designated beneficiary, and, therefore, is ineligible for the life expectancy exception of Section 72(s)(2) (and for the spousal continuation exception of Section 72(s)(3), because trusts, not being human beings, cannot marry).

Some insurers will permit a trustee of a trust named as beneficiary to elect the life expectancy option of Section 72(s)(2) over a period not extending beyond the lifetime of the oldest trust beneficiary. This is probably because they take the position that Congress intended, in enacting Section 72(s), to provide parity between the rules governing death distributions from IRAs and qualified plans and the rules governing death distributions from nonqualified annuities. Although the legislative history of Section 72(s) offers much support for this view, it should be noted that there is no specific authority for it in the IRC or regulations for annuities, as there is under IRC Section 401(a)(9) and the associated Section 1.401(a)(9) regulations with respect to see-through trust treatment for beneficiaries of retirement accounts.

1. IRC Sec. 72(s)(3).
2. IRC Sec. 72(s)(6)(A).
3. IRC Sec. 72(s)(7).
4. IRC Sec. 72(s)(5)(D).

Planning Point: Avoid naming a client's revocable living trust (or any trust, as a general rule) as the beneficiary of a nonqualified annuity if any stretch out of taxation of the gain is desired. A surviving spouse of the holder can annuitize over his or her lifetime or treat the annuity as his or her own; if that same spouse is the trustee of the decedent's trust, both opportunities probably are unavailable. *John L. Olsen, CLU, ChFC, AEP, Olsen Financial Group*.

Divorce

519. If an individual purchases an annuity contract to meet alimony payments, how are payments taxed to the recipient? What are the tax results to the purchaser?

If an annuity contract which becomes payable to a former spouse is transferred or assigned to the former spouse incident to a divorce after July 18, 1984 (unless the transfer is pursuant to an instrument in effect on or before such date), he or she "will be entitled to the usual annuity treatment, including recovery of the transferor's investment in the contract … notwithstanding that the annuity payments … qualify as alimony."[1] (If both spouses elected, the same treatment applied to a transfer made after December 31, 1983, and on or before July 18, 1984).

There is nothing in the IRC that directly supports this resolution of the conflict between the rules that "[g]ross income includes amounts received as alimony"[2] and that amounts received as an annuity under an annuity contract are taxable under rules that permit tax-free recovery of cost over the payment period.[3] If the recipient of the annuity contract is permitted to recover the purchaser's "investment in the contract," there should be no deduction allowed for the alimony by the purchaser. There is no gain taxable to the purchaser on the transfer.[4]

With respect to annuity contracts transferred before July 19, 1984, or pursuant to instruments in effect before July 19, 1984 (unless the election referred to above applies), payments under the contract to a recipient spouse in discharge of the payor spouse's alimony obligations are fully taxable to the recipient and the recipient cannot recover the payor's investment in the contract tax-free.[5] The payor spouse cannot take an income tax deduction for the payments even though they are taxable to the recipient spouse.[6] Where there is no transfer, but the payor spouse purchases an annuity, retaining ownership of the contract and receiving the payments, the payor spouse can recover his or her investment under the annuity rule. If the payor spouse then makes periodic alimony payments directly to his or her former spouse, the payor spouse can deduct the payments.[7] The recipient spouse, of course, would include the full amount of the alimony payments in gross income.[8]

1. General Explanation of the Deficit Reduction Act of 1984, at p. 711.
2. IRC Sec. 71(a).
3. IRC Sec. 72.
4. IRC Sec. 1041.
5. IRC Sec. 72(k), as then in effect; Treas. Reg. §1.72-14(b); Treas. Reg. §1.71-1(c)(2).
6. IRC Sec. 71(d), as then in effect; IRC Sec. 215, as then in effect.
7. IRC Sec. 72; IRC Sec. 215.
8. IRC Sec. 71.

Gifts and Charitable Gifts

520. May a charitable contribution deduction be taken for the gift of a maturing annuity or endowment contract?

Yes, subject to the limits on deductions for gifts to charities (Q 633). This does not necessarily mean, however, that gain at the time of gift is avoided.

If a policyholder gives an annuity contract that was issued after April 22, 1987, whether in the year it matures or in a year prior to maturity, the policyholder is treated as if received at that time the excess of the cash surrender value at the time of the transfer over the policyholder's investment in the contract.[1] Thus, the policyholder must recognize gain on the contract in the year of the gift. Given that gain is recognized, though, the policyholder's charitable deduction is equal to the full fair market value of the annuity, due to the fact that any embedded gain was recognized at the time of transfer (as otherwise the charitable gift rules limit the deductibility of ordinary income property with embedded gains).[2]

Where an endowment contract (or annuity contract) issued before April 23, 1987, is contributed before the year the contract matures, Revenue Ruling 69-102 requires that the donor include in his or her income, in the year the contract is surrendered by the donee (or matures), the excess of the cash surrender value at the time of the gift over the donor's basis. Because gain is not recognized at the time of gift, though, the IRC limits the donor's charitable deduction to the donor's cost basis.[3] (The ruling concerned a gift in the year immediately before the contract matured but may not be limited to that year).

Planning Point: A potential tax trap exists where an annuity issued before April 23, 1987 is given to a charity near the end of the donor's tax year. If the charity surrenders the annuity after the end of the donor's tax year, the donor may not deduct the value of the gift but may deduct only the donor's investment in the contract. What's more, the donor will incur income tax liability to the extent of the donor's gain in the contract in the year in which the charity takes distributions from or surrenders the annuity. *Fred Burkey, CLU, APA, The Union Central Life Insurance Company.*

For a gift to a charity in connection with purchase of an annuity from the charitable organization, see Q 530.

521. Is there a taxable gift when an individual covered under a qualified plan, a tax sheltered annuity, or an individual retirement plan irrevocably designates a beneficiary to receive a survivor benefit payable under the plan?

An irrevocable beneficiary designation would appear to be a gift falling under the broad sweep of IRC Section 2511, applying the gift tax "whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or

1. IRC Sec. 72(e)(4)(C).
2. Treas. Reg. §1.170A-4(a).
3. IRC Sec. 170(e)(1)(A).

intangible."[1] The IRS has ruled, for example, that a retiring federal employee who receives a reduced annuity to provide a survivor annuity for the beneficiary makes a gift subject to gift tax of the value of the survivor annuity by the mere act of retiring.[2]

If the beneficiary designation does trigger a gift, it will clearly be one of a future interest, which means it will not qualify for the gift tax annual exclusion.[3] If the beneficiary of the survivor annuity is the employee's spouse, however, the gift generally will qualify for the marital deduction (Q 541).[4]

522. Is there a taxable gift when a nonparticipant spouse waives the right to receive a qualified joint and survivor annuity or a qualified preretirement survivor annuity?

A waiver of the right to receive a qualified joint and survivor annuity or a qualified preretirement survivor annuity (Q 3792) by a nonparticipant spouse is not treated as a taxable transfer by the nonparticipant spouse if the waiver is made before the death of the participant spouse.[5]

523. What are the gift tax consequences to the spouse of an individual who designates a third party beneficiary to receive a survivor benefit payable under a qualified plan, a tax sheltered annuity, or an individual retirement plan if community property law applies?

If an employee's interest in a qualified plan is community property (Q 3879) and the employee gratuitously and effectively designates someone other than his or her spouse to receive a survivor benefit, the value of the benefit conveyed comes equally from the employee's community half and the employee's spouse's community half. The effect of the transaction is to create a gift from the employee's spouse of one-half the value of the benefit conveyed when the conveyance is complete.[6] The gift is considered by the IRS to be subject to gift tax.

It should be noted that community property law varies from state to state with respect to the power of a spouse to make a gift of community property without the express consent of the other spouse.

Planning Point: If a participant designates the spouse as the beneficiary of a benefit payable under a qualified plan, the participant also should provide for a contingent disposition in case the spousal beneficiary disclaims the benefit or dies first, and in such case, could provide that on death, the spousal beneficiary's interest would pass to that spouse's estate, and the participant's interest would pass to a credit shelter trust that would pay the income interest. In this manner, the participant can take advantage of the unified credit and avoid a gift as to the spouse's interest.[7]

1. IRC Sec. 2511(a); Treas. Reg. §25.2511-1(a).
2. Let. Ruls. 8715010, 8715035, 8811017.
3. Treas. Reg. §25.2503-3(c)(Ex. 2).
4. IRC Sec. 2523(f)(6).
5. IRC Sec. 2503(f).
6. IRC Sec. 2513. Prior to TRA '86, IRC Section 2517 contained an exemption from gift tax for this kind of gift.
7. BNA, Estate and Gift Tax Issues for Employee Benefits, Portfolio 378, Detailed Analysis, I.C. (3d ed.)

524. If a person who is covered under an individual retirement plan contributes to a similar plan covering his or her non-employed spouse, are such contributions considered gifts?

Yes.

These contributions generally qualify for the marital deduction, however, and do not require the filing of a gift tax return. There should be no question that an individual's contributions to a spousal IRA would qualify for the marital deduction, so long as the donee spouse is the one who names a beneficiary to receive account proceeds remaining at that spouse's death.

If the donor spouse (i.e., the contributing individual) designates a beneficiary, the donee spouse's interest in the IRA would be a nondeductible terminable interest and the marital deduction would not be allowed, except in the case of certain joint and survivor annuities (Q 541).

Withholding

525. Are amounts received under commercial annuity contracts subject to withholding?

Yes.

The payee, however, generally may elect not to have anything withheld, which is commonly chosen. In addition, only the amount that is reasonable to believe is includable in income is subject to withholding, not any return of principal payments.

If withholding occurs from periodic payments (i.e., an annuitized contract), the amounts are to be withheld at the same rate as wages. Payments are periodic, even if they are variable, if they are payable over a period of more than one year.

If payments are not periodic, 10 percent of the includable amount is withheld. Payments made to the beneficiary of a deceased payee are subject to withholding under the same rules.[1]

An election out of withholding generally will be ineffective if a payee does not furnish his or her taxpayer identification number ("TIN," usually the payee's Social Security number) to the payor or furnishes an incorrect TIN to the payor and the payor is so notified by the IRS.[2]

Payments under qualified pension, profit sharing, and stock bonus plans are discussed in Q 3868; payments under IRC Section 403(b) tax sheltered annuities are discussed in Q 3958 and Q 3959; and private annuities are discussed in Q 526.

Private Annuity

526. What is a private annuity?

A private annuity is an unsecured promise of one person (the obligor) to make fixed payments to another person (the annuitant) for life in return for the transfer of property

1. IRC Secs. 3405(a), 3405(b); Temp. Treas. Reg. §35.3405-1T (A-9, A-10, A-12, A-17, F-19 through 24).
2. IRC Sec. 3405(e)(12).

from the annuitant to the obligor. According to a general counsel memorandum, an unsecured promise to make fixed payments until a stated monetary amount is reached or until the annuitant's death, whichever occurs first, will be treated as a private annuity (instead of an installment sale with a contingent price) if the stated monetary amount would not be received by the annuitant before the expiration of his or her life expectancy (as determined under the appropriate annuity table and as determined at the time of the agreement; see Appendix A).[1]

A private annuity must be distinguished from a commercial annuity issued by a life insurance company and from an annuity payable by an organization (e.g., a charity) that issues annuities "from time to time" (Q 530, Q 532). The typical private annuity involves the transfer of appreciated property (usually a capital asset) from parents or grandparents to one or more children or grandchildren who make annuity payments in return.

527. How are payments received under a private annuity issued after October 18, 2006 taxed?

Proposed regulations, which are currently in effect, have dramatically altered the tax treatment of private annuities. Under the current rules, the receipt of an annuity contract for property will be treated as the receipt of property in an amount equal to the fair market value of the annuity contract.[2] The fair market value of an annuity contract is determined under the rules of IRC Section 7520 (Q 764). Therefore, all of the gain on the property will be recognized at the time of the exchange. The private annuity's investment in the contract will be the amount paid for the contract. Thus, where the value of the property exchanged and the value of the annuity are the same, the investment in the contract will be the fair market value of the property exchanged for the private annuity.

Planning Point: The general outcome of these rules is that subsequent payments will still be taxable to the payee under the rules for amounts received as an annuity, but the investment in the contract will be based on the fair market value of the property received in exchange for the annuity contract.[3]

These proposed regulations were intended to be effective for exchanges of property for private annuity contracts that occur after October 18, 2006. For certain transactions, however, the proposal was for a later effective date for transactions occurring after April 18, 2007. This delayed effective date was for exchanges where: (1) the issuer of the annuity is an individual; (2) the obligations under the contract are not secured; and (3) the property transferred in the exchange is not sold or otherwise disposed of during the two year period beginning on the date of the exchange. A disposition includes a transfer to a trust or any other entity, even if wholly owned by the transferor.

For tax consequences to the obligor, see Q 529.

1. GCM 39503 (5-7-86).
2. Prop. Treas. Reg. §1.1001-1(j); Prop Reg §1.72-6(e)
3. Prop. Treas. Reg. 1.72-6(e)

528. How are payments received under a private annuity issued before October 19, 2006 taxed?

The basic rules for taxing the payments received by the annuitant under a private life annuity issued before October 19, 2006 are set forth in Revenue Ruling 69-74.[1] According to this ruling, the payments must be divided into three elements: (1) a "recovery of basis" element; (2) a "gain element" eligible for capital gain treatment for the period of the annuitant's life expectancy, but taxable as ordinary income thereafter; and (3) an "annuity element" that is taxable as ordinary income. Each of these is discussed below.

(1) The portion of each payment that is to be excluded from gross income as a recovery of basis is determined by applying the basic annuity rule (Q 450). Thus, an exclusion percentage is obtained by dividing the investment in the contract by the expected return under the contract. The investment in the contract in a private annuity situation is the adjusted basis of the property transferred. If the adjusted basis of the property transferred is greater than the present value of the annuity, the annuitant's investment in the contract for purposes of IRC Section 72(b) is the present value of the annuity on the date of the exchange.[2] Expected return and annuity starting date are the same as explained in Q 459 and Q 460. Thus, expected return is obtained by multiplying one year's annuity payments by the appropriate multiple from Table I or Table V of the income tax Annuity Tables (Appendix A), whichever is applicable depending on when the investment in the contract is made, as explained in Appendix A.

If the annuity starting date is before January 1, 1987, the amount calculated to be excludable from income as a recovery of basis (as explained above) is excluded from all payments received, even if the annuitant outlives his or her life expectancy. If the annuity starting date is after December 31, 1986, then the exclusion percentage is applied only to payments received until the investment in the contract is recovered. Thereafter, the portion excludable under the percentage is included as ordinary income.[3]

(2) The capital gain portion, if any, is determined by dividing the gain by the life expectancy of the annuitant. Gain is the excess of the present value of the annuity (it may not be the same as the fair market value of the property) over the adjusted basis of the property. The present value of the annuity is obtained from the Estate and Gift Tax Valuation Tables (see Q 764). The life expectancy of the annuitant is obtained from Table I or Table V of the income tax Annuity Tables, whichever is applicable depending on when the investment in the contract is made (Appendix A). This portion is reportable as capital gain for the period of the annuitant's life expectancy, and thereafter as ordinary income. Recovery of capital gain may not be deferred until the entire investment in the contract has been recovered.[4]

(3) The remaining portion of each payment is ordinary income.

1. 1969-1 CB 43.
2. *LaFargue v. Comm.*, 800 F2d 936, 86-2 USTC ¶9715 (9th Cir. 1986), *aff'g*, TC Memo 1985-90; *Benson v. Comm.*, 80 TC 789 (1983).
3. IRC Sec. 72(b)(2).
4. *Garvey, Inc. v. U.S.*, 1 Cl. Ct. 108, 83-1 USTC ¶9163 (U.S. Cl. Ct. 1983), *aff'd*, 726 F2d 1569, 84-1 USTC ¶9214 (Fed. Cir. 1984), *cert. denied*.

If the fair market value of the property transferred exceeds the present value of the annuity (as determined from the applicable Estate and Gift Tax Valuation Tables), the difference is treated as a gift to the obligor (Q 511).[1]

> *Example*: Mrs. White is a widow, age 66, with two adult children. She owns a rental property with an adjusted basis of $30,000 and a fair market value of $135,000. On January 1, she transfers this building to her children in exchange for their unsecured promise to pay her $1,000 a month ($12,000 a year) for life beginning January 31.

Assume that the valuation table interest rate for January is 5.0 percent. Therefore, the present value of the annuity equals $126,078: $12,000 × 10.2733 (annuity factor) × 1.0227 (annuity adjustment factor). (For an explanation of the valuation table factors, see Appendix C and Example 2 thereunder). The fair market value of the property exceeds the present value of the annuity by $8,922: $135,000 – $126,078. This is a gift by Mrs. White to her children and subject to gift tax. Mrs. White's life expectancy (Table V in Appendix A) is 19.2 years.

(1) Mrs. White will exclude from gross income as a recovery of basis $130, or 13 percent of each payment (until she recovers $30,000, because her annuity starting date is after December 31, 1986). The 13 percent exclusion percentage is obtained by dividing $30,000 (investment in the contract) by $230,400 (expected return: 19.2 × $12,000) (Q 461).

(2) She will report $417 of each payment as capital gain for 19.2 years. This portion is obtained by dividing her gain of $96,078 (excess of present value of annuity [$126,078] over adjusted basis of the property [$30,000]) by 19.2, her life expectancy ($96,078 ÷ 19.2 = $5,004 a year or $417 a month). After 19.2 years, she will report this $417 as ordinary income.

(3) She will report the balance of each payment, or $453 ($1,000 – ($130 + $417)) as ordinary income. (Because her annuity starting date is after December 31, 1986, she also will report as ordinary income the portion of each payment no longer excludable as recovery of capital after her investment in the contract has been recovered).

In *Katz v. Commissioner*, the Tax Court held that a taxpayer who had exchanged shares of common stock and put options for a private annuity (on February 3, 2000) was entitled to defer recognition of capital gain relating to the transfer until the taxpayer received annuity payments.[2]

According to the Tax Court, Revenue Ruling 69-74 is not applicable if the promise to pay the annuity is secured; securing the promise will cause the entire capital gain on the transfer of the property to be taxable to the annuitant in the year of transfer. The investment in the contract would be the present value of the annuity, but not more than the fair market value of the property transferred.[3]

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1. *Benson v. Comm.*, supra; *LaFargue v. Comm.*, supra.
2. *Katz v. Comm.*, TC Memo 2008-269, citing Rev. Rul. 69-74, 1969-1 CB 43.
3. *Est. of Bell v. Comm.*, 60 TC 469 (1973); *212 Corp. v. Comm.*, 70 TC 788 (1978).

In a private letter ruling, a private annuity arrangement was still taxed as such despite the presence of a cost-of-living adjustment applicable to the monthly annuity payments and a minimum payment provision that stated that if the annuitant had not received a specified dollar amount prior to her death, the remaining amount would be paid to her estate. The annuitant also had the option to accelerate the payments and receive a lump sum amount equal to the minimum payment amount less annuity payments previously received.[1]

When a private annuity became worthless, the determination that the loss was a capital loss and not an ordinary loss was upheld in *McIngvale v. Commissioner*.[2]

Whether a transfer to a trust will be treated as a sale in exchange for a private annuity or a transfer in trust with a right to income retained depends on the circumstances in the case. Properly done, a transfer to a trust will be treated as a private annuity transaction.[3] However, purported transfers in trust were found to be sham transactions in *Horstmier v. Commissioner*.[4]

Amounts received under a private annuity contract are not subject to withholding because such amounts are not paid under a "commercial annuity," that is, one issued by a licensed insurance company.

For estate tax implications of a private annuity, see Q 551.

529. What are the tax consequences to the obligor in a private annuity transaction?

Annuity payments made by the obligor are treated as capital expenditures for the acquisition of the property. No interest deduction is allowed with respect to the payments.[5] Depreciation deductions may be taken, however, if the property is depreciable. The initial basis for depreciation is the present value of the annuity, as determined by the appropriate Estate and Gift Tax Valuation Tables (Q 764). When actual payments exceed the initial basis, the basis for depreciation is the actual payments made less prior depreciation.[6]

When payments exceed the initial basis, loss is not deductible until the property is sold.[7] If the property is sold after the annuitant's death, the obligor's basis for determining gain or loss is the total of annuity payments made less depreciation taken, if any.

If the property is sold before the annuitant's death, the obligor's basis for gain is the total payments actually made plus the actuarial value, as of the date of sale, of payments to be made in the future. The obligor's basis for loss is the total amount of payments made as of the date of sale.

1. Let. Rul. 9009064.
2. 936 F.2d 833 (5th Cir. 1991) aff'g TC Memo 1990-340.
3. See Est. of Fabric v. Comm., 83 TC 932 (1984); Stern v. Comm., 747 F2d 555, 84-2 USTC ¶9949 (9th Cir. 1984); LaFargue v. Comm., 689 F2d 845, 50 AFTR 2d 5944 (9th Cir. 1982) (followed by the Tax Court in Benson v. Comm., supra, because an appeal would go to the Ninth Circuit).
4. TC Memo 1983-409.
5. *Garvey, Inc. v. U.S.*, 1 Cl Ct. 108, 83-1 USTC ¶9163 (U.S. Cl. Ct. 1983), *aff'd*, 84-1 USTC ¶9214 (Fed Cir.), *cert. den.*, 469 U.S. 823 (1984); *Bell v. Comm.*, 76 TC 232 (1981).
6. Rev. Rul. 55-119, 1955-1 CB 352.
7. *Perkins v. U.S.*, 701 F2d 771, 83-1 USTC ¶9250 (9th Cir. 1983).

If the selling price is less than the basis for gain but more than the basis for loss, the obligor realizes neither gain nor loss. Adjustment for annuity payments made after the sale may be made by deducting loss or by reporting additional gain.[1]

Charitable Gift Annuity

530. What is a charitable gift annuity?

A charitable gift annuity agreement is a contractual obligation undertaken by a charity to pay an annuity to an individual in return for an amount transferred by the individual, where the actuarial value of the agreed upon payments is usually less than the amount contributed (notwithstanding the fact that the payments might exceed the amount transferred if the annuitant lives long enough). The contractual obligation is backed by the charity's assets. The typical charitable gift annuity can involve the transfer of appreciated property.

531. How are payments received under a charitable gift annuity agreement taxed?

The tax consequences of a charitable gift annuity involve an immediate charitable gift (deductible within the limits of IRC Section 170 (Q 633)), income tax on a portion of the annuity payments, and a recovery of principal that will be made up of part taxable gain and part excludable adjusted basis if appreciated property is transferred for the annuity.[2] Each of these is discussed below.

(1) A charitable contribution is made in the amount by which cash or the fair market value of property transferred to the charity exceeds the present value of the annuity. The American Council on Gift Annuities, a voluntary group sponsored by charitable organizations, recommends uniform annuity rates based on the annuitant's age at the date of the gift. See Table on Uniform Gift Annuity Rates in Appendix A. The uniform annuity rate is applied to the transfer and determines the amount of the annuity paid to the annuitant each year. The present value of a charitable gift annuity when issued is determined under Estate and Gift Tax Valuation Tables (Q 764).

(2) When an annuitant receives annuity payments, a percentage of each payment reflects a return of principal. This percentage (the "exclusion ratio") is determined by the basic annuity rule, that is, by dividing the investment in the contract by the expected return. The investment in the contract in the charitable annuity situation is the lesser of the present value of the annuity or the fair market value of the property transferred to the charity. The expected return is the annual annuity amount multiplied by the years of life expectancy of the donor at the time of the gift (using the applicable income tax Annuity Tables in Appendix A). If the annuity starting date is after December 31, 1986, the return of principal portion is

1. Rev. Rul. 55-119, supra.
2. See Treas. Reg. §1.1011-2(c) Ex. 8.

excludable only until the investment in the contract is fully recovered. Thereafter, that portion is included in income as ordinary income.[1]

If, however, the donor has transferred appreciated property to the charity, the donor has a gain (either a capital gain or an ordinary gain depending on the property) to the extent the fair market value of the property exceeds the donor's adjusted basis. In this situation, the bargain sale rules apply. Under these rules, proportionate portions of the donor's basis are considered part of the charitable gift and part of the investment in the annuity contract. Thus, the donor's return of principal element of each payment consists of two segments: one represents return of gain that is taxed as capital or ordinary gain, and the other represents return of the donor's adjusted basis and is excluded from the donor's income.

The portion of the gain that is taxed is the percentage that the investment in the contract bears to the total amount transferred. As long as the annuity is nonassignable, the donor may take the gain into income ratably over the donor's life expectancy. After all the gain is reported, that portion of the donor's annuity payment is excluded from income as well as the return of basis portion, if the donor's annuity starting date was before January 1, 1987. If the annuity starting date is after December 31, 1986, the IRC provides that amounts are not excludable after the investment in the contract has been recovered. Thus, it appears that once the annuitant has outlived his or her life expectancy, and recovered his or her investment in the contract, the entire payment is included in income as ordinary income.

If the donor dies before all of the gain is reported (and the donor is the sole annuitant), no further gain is reported. If the annuity starting date is after July 1, 1986, the IRC provides that if annuity payments cease by reason of the death of the sole annuitant before the investment in the contract has been recovered, the unrecovered investment in the contract may be deducted (Q 492).[2] Because the unrecovered investment in the contract where appreciated property has been given for the annuity includes the unrecognized gain portion, it is likely the deduction will be limited to the unrecovered basis.

(3) The portion of each payment in excess of the return of principal element is ordinary income.

An example of these payment rules, classified as (1) a charitable contribution, (2) return of principal, and (3) ordinary income, is shown below:

Example: Ed White is a widower, age seventy. He owns securities with an adjusted basis of $6,000 and a fair market value of $10,000. On June 1 he transfers the securities to ABC Charity in exchange for a life annuity, payable in semiannual installments. For purposes of this example, assume that the uniform annuity rate (recommended by the American Council on Gift Annuities as shown in Appendix A) is 5.7 percent, and thus the annuity payment is $570 per year.

(1) According to the applicable Estate and Gift Tax Valuation Tables (Q 764), the present value of the annuity for Mr. White is $6,261 (10.9031 [annuity factor] × 1.0074 [annuity adjustment factor for semiannual payments] × $570 [the donor's annual annuity]).

1. IRC Sec. 72(b)(2).
2. IRC Sec. 72(b)(3).

(Mr. White elected to use an interest rate for a month as explained in Q 764 with an interest rate that is assumed to be 3.0 percent for purposes of this example; Appendix C explains the derivation of Valuation Table factors from the interest rate). The difference between the $10,000 fair market value of the property and the $6,261 value of the annuity, or $3,739, is the charitable contribution portion of the transfer. According to Table V (Appendix A), Mr. White has a life expectancy of sixteen years that is adjusted to 15.8 (16 – .2) to reflect the frequency of payments (adjustment factor for semiannual payments with six months from the annuity starting date to the first payment date is -.2; see introduction to Appendix A).

(2) Of each $305 semiannual payment, 69.5 percent, or $198, represents return of principal. This percentage is found by dividing $6,261 (the value of the annuity, or investment in the contract) by $9,006 (the expected return: $570 × 15.8). Of this principal amount, $79 is gain ([$6,261 – ($6,000 × ($6,261 ÷ $10,000))] ÷ [15.8 × 2]). Mr. White must report the $79 as capital gain until all his gain is recognized, or until he dies, if that is earlier. Mr. White will exclude the balance of the principal, $119 ($198 – $79), as return of adjusted basis.

(3) The balance of each annuity payment, $87, is the amount that Mr. White must report as ordinary income ($285 – $198). After all the gain and investment in the contract has been recovered (approximately 15.8 years), each payment is fully taxable as ordinary income.

The IRS has ruled that in the case of a deferred charitable gift annuity, no amount will be considered constructively received until the annuitant begins receiving payments.[1]

The gift portion of the transfer qualifies for a gift tax charitable deduction. With respect to estate taxes, a donor who designates an annuity only for himself or herself will not have any amount relative to the gift annuity transfer included in his or her gross estate.[2]

In a private letter ruling, the IRS approved of "reinsured" charitable gift annuities.[3]

532. What are the tax consequences to the obligor in a charitable annuity transaction?

Property transferred in return for a charitable gift annuity could fall into the general definition of "debt financed property" in IRC Section 514(b)(1) because the charity acquires the gift subject to the promise to pay the donor an annuity. This result would be problematic, because it could be treated as unrelated business taxable income and trigger an associated unrelated business income tax for the charity.

However, in a private letter ruling, the IRS decided that issuing a charitable gift annuity will not result in income from an unrelated trade or business and that income earned by the

1. Let. Rul. 200742010.
2. See Rev. Rul. 80-281, 1980-2 CB 282; Let. Rul. 8045010. See also IRC Sec. 2522(a) and IRC Sec. 2503(a).
3. See Let. Rul. 200847014.

charitable organization from investing the charitable gift annuity funds will not be considered unrelated debt-financed income.[1]

A charity's obligation to pay an annuity will be exempt from the debt financed property rules of IRC Section 514 if the following conditions are met:

(1) the annuity must be the sole consideration paid for the property transferred;

(2) the present value of the annuity must be less than 90 percent of the value of the property received in exchange;

(3) it must be payable over the lives of one or two annuitants;

(4) the contract must not guarantee a minimum number of payments or specify a maximum number of payments; and

(5) the contract must not provide for adjustments to the amount of annuity paid based on income earned by the transferred property or any other property.[2]

Issuing charitable gift annuities does not affect the tax-exempt status of the organization if the annuity meets the requirements above and a portion of the amount transferred in return for the annuity is allowable as a charitable deduction.[3]

Taxation

533. How is a corporation taxed on payments under an annuity contract or on living proceeds from an endowment or life insurance contract?

With respect to living proceeds from endowment and life insurance contracts, the same rules that are applicable to personal insurance and endowment contracts generally apply (Q 10 to Q 61).[4] The same rules that apply to increases in the cash value of policies for personal insurance (Q 8) also apply to business-owned insurance.

In the case of a deferred annuity contract held by a corporation or other entity that is not a natural person, to the extent that contributions are made after February 28, 1986, the contract is not treated as an annuity contract for tax purposes. Income on the contract is treated as ordinary income received or accrued by the owner during the taxable year.[5] Thus, if the total of payments received in a year, amounts received in prior years, and the net surrender value at the end of the year, if any, exceed premiums paid in the current year and in prior years, plus amounts included in income in prior years, then the excess amount is includable in income. The rule and exceptions are discussed in Q 439. To the extent an annuity contract is not subject to this rule (i.e., contributions were made prior to March 1, 1986), payments received under the contract will be subject to the rules applicable to personal annuity contracts.

1. Let. Rul. 200449033.
2. IRC Sec. 514(c)(5).
3. IRC Sec. 501(m).
4. IRC Sec. 11(a).
5. IRC Sec. 72(u).

534. How are damage payments taxed if an annuity is used to fund a judgment or settle a claim for damages on account of personal injuries or sickness?

Other than punitive damages, any damages received on account of personal physical injuries or physical sicknesses are not includable in gross income. This is true whether the damages are received by suit or agreement or as a lump sum or periodic payments.[1] For this purpose, emotional distress is not treated as a physical injury or physical sickness.[2]

The phrase "other than punitive damages" does not apply to punitive damages awarded in a wrongful death action with respect to which applicable state law, as in effect on September 13, 1995, provides that only punitive damages may be awarded in such an action.[3]

The rule regarding emotional distress does not apply to any damages that do not exceed the amount paid for medical care, as described generally in IRC Section 213, attributable to emotional distress.

If a lump sum payment representing the present value of future damages is invested for the benefit of a claimant who has actual or constructive receipt or the economic benefit of the lump sum, only the amount of the lump sum payment is treated as received as damages and excludable. None of the income from investment of the payment is excludable.[4]

Where damages are to be paid periodically and the person injured has no right to the discounted present value of the payments or any control over investment of the present value, the entire amount of each periodic payment is excludable, including earnings on the fund.

Thus, where a single premium annuity is purchased by a person obligated to make the damage payments to provide that person with a source of funds, and the person receiving payments has no interest in the contract and can rely only on the general credit of the payor, the entire amount of each periodic payment is excludable.[5]

Under proposed regulations issued in 2009, damages for physical injuries may qualify for the Section 104(a)(2) exclusion even though the injury giving rise to the damages is not defined as a tort under state or common law. In addition, the exclusion does not depend on the scope of remedies available under state or common law. In effect, the regulations reverse the result in *United States v. Burke*[6] by allowing the exclusion for damages awarded under no-fault statutes.[7]

535. What is the requirement to maintain minimum essential coverage?

For taxable years ending after December 31, 2013, the new law requires an applicable individual to ensure that the individual, and any dependent of the individual who is an applicable

1. IRC Sec. 104(a).
2. IRC Sec. 104(a).
3. IRC Sec. 104(c).
4. Rev. Rul. 65-29, 1965-1 CB 59; Rev. Rul. 76-133, 1976-1 CB 34.
5. Rev. Rul. 79-220, 1979-2 CB 74; Let. Rul. 8321017.
6. 504 U.S. 229 (1992).
7. Reg-127270-06, 74 Fed. Reg. 47152, 47153 (9-15-2009); see Treas. Reg. §1.104-1(c)(2).

individual, is covered under a health insurance plan that provides minimum essential coverage or else pay a penalty.[1]

Applicable individual means, with respect to any month, an individual other than individuals who have religious exemptions, individuals not lawfully present in the United States, and incarcerated individuals.[2]

No penalty will be imposed on an individual who falls under one of the following exemptions:

(1) an individual whose required contribution for coverage for the month exceeds 8 percent (as indexed after 2014) of the individual's household income for the most recent taxable year (household income is increased by any exclusion from gross income for any portion of the required contribution made through a salary reduction arrangement);

(2) taxpayers with income that is less than the amount of the tax exemption on gross income specified in Section 6012(a)(1);

(3) members of Indian tribes;

(4) months during short coverage gaps (generally, any month the last day of which occurred during a period in which the applicable individual was not covered by minimum essential coverage for a continuous period of fewer than three months); and

(5) any applicable individual who for any month is determined by the Secretary of Health and Human Services to have suffered a hardship with respect to the capability to obtain coverage under a qualified health plan.[3]

536. When does a taxpayer have minimum essential coverage in order to avoid becoming subject to the Affordable Care Act penalty after 2013?

Minimum essential coverage means coverage under any of the following:

(1) government sponsored programs (Medicare, Medicaid, the Children's Health Insurance Program, the TRICARE for Life program, the veterans' health care program, the health plan for Peace Corps volunteers, and the Nonappropriated Fund Health Benefits Program of the Department of Defense);

(2) an eligible employer sponsored plan, which means with respect to any employee, a group health plan or group health insurance coverage offered by an employer to the employee that is a governmental plan or any other plan or coverage offered in the small or large group market within a state (including grandfathered health plans);

1. IRC Secs. 5000A(a), 5000A(b)(1), 5000A(d), as added by PPACA 2010.
2. IRC Secs. 5000A(d)(2), 5000A(d)(3), 5000A(d)(4), as added by PPACA 2010.
3. IRC Sec. 5000A(e), as added by PPACA 2010, as amended by HCEARA 2010.

(3) plans in the individual market (coverage under a health plan offered in the individual market within a state);

(4) grandfathered health plans; and

(5) other health benefits coverage (e.g., a state health benefits risk pool), as the Secretary of Health and Human Services recognizes for this purpose).[1]

537. What is the penalty for an individual who chooses to remain uninsured?

If a taxpayer who is an applicable individual, or an applicable individual for whom the taxpayer is liable, fails to meet the requirement of maintaining minimum essential coverage for one or more months, a penalty will be imposed on the taxpayer.[2] If an individual on whom a penalty is imposed files a joint return for the taxable year including that month, the individual and spouse will be jointly liable for the penalty.[3]

The penalty schedule is shown in the Uninsured Penalty Table, below.[4]

Uninsured Penalty Table

Year	Flat Penalty Per Adult	Flat Penalty Under Age 18	Household Maximum Penalty	Income Percentage Penalty
2014	$95	$47.50	$285	1%
2015	$325	$162.50	$975	2%
2016	$695*	$347.50*	$2,085*	2.5%

* Indexed for inflation after 2016

If the penalty applies, a flat penalty applies per each uninsured adult or child under age eighteen in a household. The penalty is increased to an amount equal to the income percentage multiplied by the amount of household income in excess of the income tax return filing threshold, if that is greater than the flat penalty. The dollar amount penalty cannot be greater than the household maximum penalty, which is 300 percent of the flat dollar amount[5]; in the case of the income percentage penalty, it cannot be greater than an amount equal to the national average premium for a bronze plan for the applicable family size involved.[6]

1. IRC Sec. 5000A(f), as added by PPACA 2010.
2. IRC Sec. 5000A(b)(1), as added by PPACA 2010, as amended by PPACA 2010 Section 10106, as further amended by HCEARA 2010.
3. IRC Sec. 5000A(b),(3)(B), as added by of PPACA 2010 Section 1501(b).
4. IRC Sec. 5000A(c), as added by of PPACA 2010 Section 1501(b), as amended by PPACA 2010 Section 10106, as further amended by HCEARA 2010.
5. IRC Sec. 5000A(c), as added by of PPACA 2010 Section 1501(b), as amended by PPACA 2010 Section 10106, as further amended by HCEARA 2010.
6. IRC Sec. 5000(A)(c)(1)(B)

538. If a qualified plan trust distributes an annuity contract to an employee, is the value of the contract taxable to the employee in the year of distribution?

If the contract distributed is an annuity contract, the employee will not be taxed on its value, including cash surrender value that may be available to the employee on surrender, unless and until the employee surrenders the contract.[1]

Rather, the employee will be taxed on the annuity payments as he or she receives them (Q 539, Q 540). A contract issued after 1962 must be nontransferable to qualify for this tax deferred treatment.[2] The transfer of an annuity to a divorced spouse pursuant to a divorce decree will not violate the nontransferability requirement.[3]

The IRS determined that the nontransferability requirement was not violated by a Section 1035 exchange of an annuity contract distributed from a qualified plan where the taxpayer simply was uncomfortable with the amount of funds invested with a single insurer.[4] Both the old and new contracts were materially similar, were nontransferable, were subject to the spousal consent requirements, and met the other applicable IRC Section 401 requirements.[5]

If an employee surrenders an annuity contract after the year of distribution, the gain realized on surrender is taxable as ordinary income and will not qualify for taxation as a lump sum distribution.[6] The unsurrendered annuity contract will affect the taxation of any lump sum distribution of which it is a part, or that is made in the same year, as explained below. If the annuity is surrendered in the year of distribution, the proceeds either will be taxed as ordinary income, or, if the distribution of the annuity is all or part of a lump sum distribution, under the lump sum distribution rules (Q 3862). If an annuity is distributed in an eligible rollover distribution, tax may be deferred by rollover (Q 3883).

According to proposed regulations, an employee's cost basis is deducted first from the cash and property other than the annuity. Any excess is used to reduce the value of the annuity.[7]

Amounts that become payable in cash under qualified plans are not includable in income simply because they are available.[8] Thus, where a plan provides that an employee, on termination of employment, may take either a single sum payment in cash or have the trustee purchase an annuity for the employee with cash, the employee's election does not have to be made within any specific time after the cash became available. Plan distribution provisions must satisfy applicable distribution requirements (Q 3801 to Q 3813).

1. Treas. Reg. §1.402(a)-1(a)(2).
2. IRC Sec. 401(g); Treas. Reg. §1.401-9(b)(1).
3. Let. Rul. 8513065.
4. Let. Rul. 9233054, GCM 39882 (10-30-92).
5. See also Let. Rul. 9241007.
6. Rev. Rul. 81-107, 1981-1 CB 201.
7. Prop. Treas. Reg. §1.402(e)-2(c)(1)(ii)(C).
8. *See* IRC Sec. 402(a).

539. How is an employee taxed on periodic retirement benefits under a qualified pension, annuity, or profit sharing plan?

If an employee, whether a regular employee or a self-employed individual, has no cost basis for his or her interest in a plan, the full amount of each payment is taxable to the employee as ordinary income.[1] If an employee has a cost basis for his or her interest in a plan, the payments are taxed as discussed below, depending on the employee's annuity starting date. To determine an employee's cost basis, see Q 3864.

The tax treatment is the same whether payment is made directly from a qualified trust or annuity plan or whether a trust buys an annuity and distributes it to an employee.[2] Distribution of an annuity contract itself affects the tax on lump sum distributions (Q 135). If an employee has a cost basis for his or her interest, payments are taxed as discussed below, depending on the annuity starting date.

Annuity Starting Date after December 31, 1997

For an employee who has a cost basis for his or her interest, and whose annuity starting date is after December 31, 1997, the investment in the contract is recovered according to one of two schedules set forth in the IRC. For purposes of this rule, the employee's investment in the contract does not include any adjustment for a refund feature under the contract.[3]

These tables operate in the same manner as the simplified safe harbor announced in 1988.[4] If an annuity is payable over one life, the payments will be taxed as described below for annuities with a starting date after November 18, 1996. If the annuity is payable over two or more lives, the excludable portion of each monthly payment is determined by dividing the employee's investment in the contract by the number of anticipated payments, as follows:[5]

If the combined ages of the annuitants are	Number of payments
110 and under	410
111–120	360
121–130	310
131–140	260
141+	210

According to the Conference Committee Report for TRA '97, this table applies to benefits based on the life of more than one annuitant, even if the amount of the annuity varies by annuitant. It does not apply to an annuity paid on a single life merely because it has additional features, such as a term certain. In the case of a term certain annuity without a life contingency, the expected

1. Treas. Regs. §§1.61-11(a), 1.72-4(d)(1); IRC Secs. 402(a), 403(a).
2. IRC Secs. 402(a), 403(a)(1).
3. IRC Secs. 72(d)(1)(C), 72(c)(2); see Notice 98-2, 1998-1 CB 266.
4. See IRC Sec. 72(d); Notice 98-2, 1998-1 CB 266.
5. IRC Sec. 72(d)(1).

number of payments is the number of monthly payments provided under the contract.[1] In the case of payments made other than monthly, an adjustment must be made to take into account the period on the basis of which payments are made. Two methods of making such an adjustment are set forth in Notice 98-2.[2]

For purposes of this rule, if an annuity is payable to a primary annuitant and more than one survivor annuitant, the combined ages of the annuitants is the sum of the age of the primary annuitant and the youngest survivor annuitant. If an annuity is payable to more than one survivor annuitant but there is no primary annuitant, the combined ages of the annuitants is the sum of the age of the oldest survivor annuitant and the youngest survivor annuitant. Any survivor annuitant whose entitlement to payments is based on an event other than the death of the primary annuitant is disregarded. For an explanation of the basis recovery rules under IRC Section 72(d), see Letter Ruling 200009066

Annuity Starting Date after November 18, 1996 and before January 1, 1998

If an employee had a cost basis for his or her interest, and the annuity starting date was after November 18, 1996 and before January 1, 1998 (or if the annuity is payable over one life and has a starting date after December 31, 1997, as described above), the investment in the contract was recovered according to the schedule below. For purposes of this rule, the employee's investment in the contract did not include any adjustment for a refund feature under the contract.[3]

The excludable portion of each monthly payment was determined by dividing the employee's investment in the contract by the number of anticipated payments contained in the following table:[4]

Age	Number of Payments
55 and under	360
56–60	310
61–65	260
66–70	210
71+	160

This table did not apply if the annuitant was age seventy-five or older unless there were fewer than five years of guaranteed payments under the annuity.[5] It would appear that for an annuitant who was seventy-five or older and whose contract provides for five or more years of guaranteed payments, the rules for annuities with a starting date after July 1, 1986 and before November 19, 1996 would be applied.

1. Notice 98-2, 1998-1 CB 266.
2. 1998-1 CB 266.
3. IRC Secs. 72(d)(1)(C), 72(c)(2); see Notice 98-2, 1998-1 CB 266.
4. IRC Sec. 72(d)(1)(B).
5. IRC Sec. 72(d)(1)(E).

If a contract provided for a fixed number of installment payments, the number of monthly annuity payments provided under the contract was used instead of the number listed on the table.[1] If payments under a contract were not made on a monthly basis, appropriate adjustments had to be made to the number of payments determined above to reflect the basis on which payments are made.[2]

The excluded amount remained constant, even where the amount of the annuity payments changes. If the amount to be excluded from each payment was greater than the amount of the annuity payment (e.g., because of decreased survivor payments), then each annuity payment would be completely excluded from gross income until the entire investment is recovered. As noted below, under earlier law, for distributees with annuity starting dates after December 31, 1986, annuity payments received after the investment was recovered are fully includable in gross income. If two annuitants are receiving payments at the same time, each may exclude his or her pro rata portion of the amount provided under these rules.[3]

If a lump sum was paid to a taxpayer in connection with the commencement of the annuity payments, it was taxable as an amount not received as an annuity under IRC Section 72(e) and treated as received before the annuity starting date. The taxpayer's investment in the contract was determined as if the lump sum payment had been received.[4] Where a defined benefit plan required after-tax contributions permitted participants to withdraw their aggregate after-tax contributions in a single sum at retirement in exchange for an actuarial reduction in their lifetime pension benefits, the IRS ruled that the single sum payment constituted a lump sum payment under IRC Sections 72(d)(1)(D) and 72(d)(1)(G).[5]

The total amount that an employee could exclude was not permitted to exceed his or her investment in the contract, and if the employee died prior to recovering his or her full investment in the contract, any unrecovered investment will be allowable as a deduction on the employee's final return.[6]

Special transition rules were provided for payors and distributees who continued using the simplified safe harbor contained in Notice 88-118, as revised by Notice 98-2, with respect to annuities with annuity starting dates after November 18, 1996 and before January 1, 1997.[7]

Annuity Starting Date after July 1, 1986 and before November 19, 1996

If an employee had a cost basis for his or her interest and the annuity starting date was after July 1, 1986 and before November 19, 1996, payments were taxed either under the regular annuity rules or, if certain requirements were met, under the simplified safe harbor method described below.[8]

1. See IRC Secs. 72(d)(1)(B)(i)(II), 72(c)(3)(B).
2. IRC Sec. 72(d)(1)(F); see Notice 98-2, 1998-1 CB 266, for two such methods.
3. Notice 98-2, 1998-1 CB 266.
4. IRC Sec. 72(d)(1)(D).
5. Let. Rul. 9847032.
6. IRC Secs. 72(d)(1)(B)(ii), 72(b)(2), 72(b)(3); see Notice 98-2, 1998-1 CB 266.
7. See Notice 98-2, 1998-1 CB 266.
8. IRC Secs. 402(a), 72, 403(a).

Under the regular annuity rules, an exclusion ratio was determined as of the annuity starting date.[1] Basically, the exclusion ratio was determined by dividing the investment in the contract by the expected return under the contract. The resulting quotient was the percentage of each payment that may be excluded from gross income.

With respect to distributions from qualified plans, the employee's cost basis in the plan was his or her investment in the contract (Q 450, Q 3864). The total amount that an employee was estimated to receive under a plan was his or her expected return (Q 459). In the case of a straight life annuity, this expected return was determined by multiplying the total amount an employee will receive each year by the number of years in the employee's life expectancy, according to Table I or Table V of the Annuity Tables, whichever was applicable (Appendix A). For an explanation of the basic annuity rule and its application to various types of payments (e.g., straight life annuity, refund or period-certain life annuity, joint and survivor annuity, or payments for a fixed period), see Q 450 to Q 470. If an employee's annuity starting date was after December 31, 1986, the total amount that the employee could exclude during his or her lifetime was limited to his or her investment in the contract. With respect to earlier starting dates, the exclusion ratio continued to apply, even to amounts received in excess of the employee's investment in the contract.

> *Example*: Mr. Rowles retired on October 9, 1996, at the age of sixty-five. He had the option under his employer's qualified contributory pension plan to elect an annuity for a period certain, but chose instead to receive a life annuity. On January 1, 1997, he started receiving payments under the plan. The pension arrangement pays him $800 a month for life. Mr. Rowles' cost basis in the plan (including his own contributions and amounts that have been taxed to him) is $12,000. Mr. Rowles made contributions both before July 1, 1986, and after June 30, 1986, but because Mr. Rowles could have elected an annuity for a period certain, he may not elect to calculate his excludable amount separately with respect to the pre-July and post-June portions (Appendix A). The life expectancy for age sixty-five is twenty years (Table V, Appendix A). So, the total expected return from the plan is $192,000 (20 × $9,600). Mr. Rowles' exclusion ratio is therefore $12,000/$192,000, or 6.3 percent. Each year he excludes $604.80 (6.3 percent of $9,600) from gross income, until he has excluded the full $12,000, and each year he includes in gross income $8,995.20 ($9,600 – $604.80), until the full $12,000 has been recovered, after which he will include the full $9,600.

If an employee dies prior to recovering his or her full investment in the contract, the unrecovered investment will be allowed as a deduction on the employee's final return. If payments are guaranteed and a refund beneficiary does not recover the amount unrecovered at the decedent's death, the beneficiary may deduct the remaining unrecovered investment in the contract.[2]

Annuity Starting Date on or Before July 1, 1986

If an employee's annuity starting date was on or before July 1, 1986, payments were taxed according to the three year cost recovery rule or the regular annuity rules.[3] The three year cost recovery rule was repealed for employees with an annuity starting date after July 1, 1986.[4]

1. IRC Sec. 72(b); Treas. Reg. §1.72-4(a).
2. IRC Sec. 72(b)(3).
3. IRC Sec. 72(d)(1), prior to repeal.
4. TRA '86, Sec. 1122(c)(1).

Certain premature distributions are subject to an additional tax (Q 3860). Excess retirement distributions were subject to an additional tax in years beginning before 1997.

Simplified "Safe Harbor" Method

In the case of an annuity starting date before November 19, 1996, a simplified safe harbor method can be used if annuity payments depend on the life of the employee or the joint lives of the employee and a beneficiary. If an employee was age seventy-five or older when annuity payments commenced, this method could be used only if fewer than five years of payments were guaranteed.[1] Under this method, investment in the contract is the employee's cost basis in the plan. No refund feature adjustment has to be made. Investment in the contract is divided by the total number of monthly annuity payments expected. This number is taken from the following table and is based on the employee's age at the annuity starting date:

Age	Number of Payments
55 and under	300
56–60	260
61–65	240
66–70	170
71+	120

The same expected number of payments applies regardless of whether the employee is receiving a single life annuity or a joint and survivor annuity. The dollar amount excluded from each payment does not change, even if the amount of the payments increases or decreases.[2] If an annuity starting date is after December 31, 1986, annuity payments received after the investment in the contract is recovered are fully includable in income.

An employee makes the election to use the safe harbor method by reporting the taxable portion of the annuity payments received in the year, including the annuity starting date under that method, on the income tax return for that year and for succeeding years. An employee may change the method used to report the tax treatment of annuity payments (i.e., from the safe harbor method to the actual calculation of an exclusion ratio or vice versa) by filing an amended return for all open tax years, as long as the year containing the annuity starting date is an open year.[3]

540. How are variable annuity benefits payable under a qualified pension or profit sharing plan taxed to an employee?

If an employee has no cost basis for an interest in a plan, each payment, regardless of amount, is fully taxable as ordinary income. An employee's cost basis generally consists of any nondeductible contributions the employee has made to the plan and any employer contributions

1. Notice 88-118, 1988-2 CB 450.
2. Notice 88-118, 1988-2 CB 450.
3. Notice 88-118, 1988-2 CB 450.

that have been taxed to the employee, other than excess deferrals (Q 3705) not timely distributed (Q 3864).

When an employee has a cost basis for an interest in a plan and the annuity starting date is after June 30, 1986, payments are taxed under the annuity rules as expressly applied to variable payments (Q 476 to Q 478). Thus, the amount excludable from an employee's gross income each year is determined by dividing the cost basis, adjusted for any refund or period-certain guarantee, by the number of years in the payment period. If an annuity is payable for a life or lives, the payment period is determined by the IRS annuity tables.

For annuities with a starting date after December 31, 1986, the present value of any refund feature is not to be taken into account in calculating the unrecovered investment in the contract, but these amounts still are taken into account in calculating an individual's exclusion ratio.[1] The unrecovered investment in a contract affects only those annuitants who die before the annuity payments end (i.e., the amount of their deduction on their final year return) (Q 492) and the annuitant's cost recovery date (i.e., the date upon which the annuity holder recovers his or her investment in the contract).

Example: Mr. Mounger retired on August 31, 2014 when he had reached age sixty-five. He became eligible to receive monthly variable annuity payments for life under an earlier contributory pension plan of his employer. In the event of Mr. Mounger's death before receiving payments for at least five years, payments on the same variable basis will be continued to his beneficiary for the remainder of the five year period. Mr. Mounger contributed $6,000 to the plan ($5,000 representing investment in the contract before July 1, 1986; $1,000 representing investment in the contract after June 30, 1986). Payments for the first year began in September, and during the last four months of the year, Mr. Mounger received a total of $640. Mr. Mounger elects to determine his excludable amount by making separate calculations for his pre-July 1986 and post-June 1986 investment in the contract. The value of the refund feature determined under Table VII of section 1.72-9 is not more than 50 percent, and Mr. Mounger had only life annuity options available. On the basis of these facts, Mr. Mounger's annual exclusion from gross income will be $343.60. The first step is to adjust the investment in the contract for the value of the refund feature, as follows:

Pre-July 1986 adjustment:	
Unadjusted investment in the contract	$5,000
Allocable part of amount to be received annually (($5,000 ÷ $6,000) × $1,920)	$1,600
Duration of guaranteed amount (years)	5
Guaranteed amount (5 × $1,600)	$8,000
Percentage in Table III for age 65 and 5 years	7%
Present value of refund feature rounded to nearest dollar (7% of $8,000)	$ 560
Adjusted pre-July 1986 investment in the contract ($5,000 – $560)	$4,440
Post-June 1986 adjustment:	
Unadjusted investment in the contract	$1,000
Allocable part of amount to be received annually (($1,000 ÷ $6,000) × $1,920)	$ 320
Duration of guaranteed amount (years)	5

1. IRC Sec. 72(b)(1),(2).

Guaranteed amount (5 × \$320)	\$1,600
Percentage in Table VII for age 65 and 5 years	3%
Present value of refund feature rounded to nearest dollar (3% of \$1,600)	\$ 48
Adjusted post-June 1986 investment in the contract	\$ 952

Once the investment in the contract has been adjusted by subtracting the value of the period-certain guarantee, an excludable amount is determined by dividing the adjusted investment in the contract by the life expectancy taken from Table I or V. Taking the example above, the excludable amount is determined as follows:

Pre-July 1986 investment in the contract (adjusted for period-certain guarantee)	\$ 4,440
Life expectancy from Table I (male age 65)	15 years
Excludable amount (\$4,440 ÷ 15)	\$ 296
Post-June 1986 investment in the contract (adjusted for period-certain guarantee)	\$ 952
Life expectancy from Table V (age 65)	20 years
Excludable amount (\$952 ÷ 20)	\$ 47.60
Amount excludable from gross income each year (\$296 + \$47.60)	\$343.60

In the case of an annuity starting date before November 19, 1996, a simplified safe harbor method may be available (Q 539).

With respect to annuities with starting dates prior to July 1, 1986, payments are taxed under the annuity rules or under the three year cost recovery rule (Q 539).

Certain early (premature) distributions are subject to an additional tax (Q 3860).

541. Does the interest of a donee spouse in a joint and survivor annuity qualify for the marital deduction?

The interest of a donee spouse in a joint and survivor annuity in which only the donor and donee spouses have a right to receive payments during the spouses' joint lifetimes is treated as a qualified terminable interest property ("QTIP") for which the marital deduction is available unless the donor spouse irrevocably elects otherwise within the time allowed for filing a gift tax return.[1]

Estate Tax

542. What are the estate tax results when a decedent has been receiving payments under an annuity contract?

If a decedent was receiving a straight life annuity, there is no property interest remaining at the decedent's death to be included in the decedent's gross estate, as payments terminated at death.

1. IRC Sec. 2523(f)(6).

If a contract provides a survivor benefit (as under a refund life annuity, joint and survivor annuity, or installment option), tax results depend on whether the survivor benefit is payable to a decedent's estate or to a named beneficiary and, if payable to a named beneficiary, on who paid for the contract.

If payable to a decedent's estate, the value of the post-death payment or payments is includable in the decedent's gross estate under IRC Section 2033 as a property interest owned by the decedent at the time of his or her death. If payable to a named beneficiary, the provisions of IRC Section 2039(a) and IRC Section 2039(b) generally apply and inclusion in the gross estate is determined by a premium payment test. Thus, if a decedent purchased the contract (after March 3, 1931), the value of the refund or survivor benefit is includable in the decedent's gross estate.

In the event a decedent furnished only part of the purchase price, the decedent's gross estate includes only a proportional share of this value (Q 544 to Q 548).

The foregoing rules do not apply to death proceeds of life insurance on the life of a decedent (Q 76). In addition, special statutory provisions apply to employee annuities under qualified pension and profit-sharing plans (Q 3877, Q 3878), to certain other employee annuities (Q 552, Q 553), and to individual retirement plans (Q 3659).

543. What are the estate tax results when a decedent has been receiving payments under an optional settlement of endowment maturity proceeds or life insurance cash surrender value?

Life insurance or annuity proceeds payable to a surviving spouse qualify for the marital deduction if certain conditions are met (Q 186). If proceeds used the marital deduction in the first spouse's estate and the contract provides a survivor benefit to the surviving spouse's estate or to a person surviving the surviving spouse, then the proceeds usually are includable in the surviving spouse's estate.

If the surviving spouse receives a straight life annuity, there is no property interest remaining at his or her death to be included in his or her gross estate.

544. If an individual purchases a deferred or retirement annuity and dies before the contract matures, is the death value of the contract includable in his or her estate?

Generally, yes.

The amount payable on death before maturity is not life insurance and, therefore, the estate tax rules for annuities apply.

If a death benefit is payable to an annuitant's estate, its value is includable in the gross estate under IRC Section 2033, and it is considered to be a property interest owned by the annuitant at the time of death.

If a death benefit is payable to a named beneficiary and an annuitant purchased the contract after March 3, 1931, the value of the death benefit generally is includable in the gross estate under IRC Section 2039, whether or not the right was reserved to change the beneficiary. If the individual purchased the annuity as a gift for another person, and retained no interest in the annuity payments, incidents of ownership, or refunds, the value of the annuity ordinarily will not be includable in the individual's gross estate (Q 549).

The same rules apply to the proceeds of a retirement income endowment if the insured dies after the terminal reserve value equals or exceeds the face value.[1]

For example, an employer purchases a contract from an insurance company to provide an employee, upon retirement at age sixty-five, with an annuity of $100 per month for life, and continues to pay a similar annuity to his beneficiary upon the employee's death after retirement. The contract provides that if the employee dies before reaching retirement age, a lump sum payment of $20,000 will be paid to his beneficiary instead of the annuity. Assume that the reserve value of the contract at the retirement age is $20,000. If the employee dies after reaching retirement age, the death benefit to the beneficiary would be an annuity, which would be includable in the employee's gross estate under Section 2039 (a) and (b). If, on the other hand, the employee dies before reaching his retirement age, the death benefit to the beneficiary would be insurance under a policy on the life of the decedent since the reserve value would be less than the death benefit.[2]

545. In the case of a joint and survivor annuity, what value is includable in the gross estate of the annuitant who dies first?

The value of a survivor's annuity is includable in the deceased annuitant's gross estate in proportion to his or her contribution to the purchase price of the contract.[3] (This rule applies to contracts purchased after March 3, 1931).

Thus, if a deceased annuitant purchased the contract, the full value of the survivor's annuity is includable in his or her gross estate. If the survivor purchased the contract, no part of the value is includable in the deceased annuitant's estate. If both contributed to the purchase price, only a proportionate part of the value is includable in the deceased's estate.

For example, suppose that the decedent and his wife each contributed $15,000 to the purchase price of a joint and survivor annuity payable for their joint lives and the life of the survivor. If the value of the survivor's annuity is $20,000 at the decedent's death, the amount to be included in his gross estate is one-half of $20,000 ($10,000) since he contributed one-half of the cost of the contract.[4]

In accord with this rule, if a joint and survivor annuity is purchased with community funds, only one-half of the value of the survivor's annuity is includable in the gross estate of the spouse who dies first.[5] (For estate tax value of survivor's annuity, see Q 546).

1. Treas. Reg. §20.2039-1(d).
2. Treas. Reg. §20.2039-1(d)(Ex.).
3. IRC Secs. 2039(a), 2039(b).
4. Treas. Reg. §20.2039-1(c)(Ex. 1).
5. *Est. of Mearkle v. Comm.*, 129 F.2d 386 (3d Cir. 1942); *Comm. v. Est. of Wilder*, 118 F.2d 281 (5th Cir. 1941).

Where a joint and survivor annuity between spouses is treated as qualifying terminable interest property for gift tax purposes (Q 541) and the donee spouse dies before the donor spouse, nothing is included in the donee spouse's estate by reason of the qualifying interest.[1] Where the survivor is the deceased annuitant's spouse, the value of the survivor's annuity will qualify for the marital deduction if the contract satisfies applicable conditions (Q 186).

Planning Point: A joint and survivor annuity between spouses usually will escape estate tax in both spouse's estates because of the marital deduction and because the annuity ends at the survivor's death.

546. What is the estate tax value of a survivor's annuity under a joint and survivor annuity contract?

The value is the amount the same insurance company would charge the survivor for a single life annuity as of the date of the first annuitant's death.[2] Where it can be proven that the survivor's life expectancy is below average, it may be possible to obtain a valuation based on the survivor's actual life expectancy at the date of the decedent's death.[3] For example, lower valuation has been obtained on proof that the surviving annuitant's life expectancy was short because of an incurable disease.[4]

Even if an executor elects to value estate assets as of six months after death (alternate valuation), a survivor's annuity is valued at the date of death. The date of death value is used, despite the election of an alternate valuation, where any change in value after death is due only to lapse of time.

If a surviving annuitant dies during the six months following the first annuitant's death, a lower valuation may be obtained by electing alternate valuation. Thus, in one case, where the survivor died before the optional valuation date, the value at the optional valuation date was determined by subtracting the cost of an annuity as of the survivor's date of death from the cost of an annuity as of the first annuitant's date of death.[5]

547. In the case of a refund or period-certain annuity, is the balance of the guaranteed amount, payable after annuitant's death, includable in the annuitant's gross estate?

If payable to the annuitant's estate, it is includable in his gross estate under IRC Section 2033, as a property interest owned by him at death.

If payable to a named beneficiary, and the *annuitant* purchased the contract (after March 3, 1931), it is includable in the annuitant's gross estate under IRC Section 2039(a). It is immaterial whether the beneficiary designation was revocable or irrevocable.

1. IRC Sec. 2523(f)(6).
2. Treas. Reg. §20.2031-8(a)(3) (Ex.1); *Est. of Mearkle v. Comm.*, 129 F.2d 386 (3d Cir. 1942); *Est. of Welliver v. Comm.*, 8 TC 165 (1947); *Est. of Pruyn v. Comm.*, 12 TC 754 (1949), *rev'd*, 184 F.2d 971 (2d Cir. 1950); *Christiernin v. Manning*, 138 F. Supp. 923 (D.N.J. 1956).
3. *Est. of Jennings v. Comm.*, 10 TC 323 (1948).
4. *Est. of Halliday by Denbigh v. Comm.*, 7 TC 387 (1946), *acq.*, 1953-1 CB 4; *Est. of Hoelzel v. Comm.*, 28 TC 384 (1957), *acq.*, 1957-2 CB 3.
5. *Est. of Hance v. Comm.*, 18 TC 499 (1952).

If the refund beneficiary is a charitable organization, the value is included in the annuitant's estate, but the estate is also entitled to a charitable deduction for the value of the transfer to the charitable organization.[1] However, where a decedent has directed his executor to purchase a refund annuity for a personal beneficiary and to name a charitable organization as a refund beneficiary, the decedent's estate is not entitled to a charitable deduction for the value of the refund.[2]

548. Are death proceeds payable under a single premium annuity and life insurance combination includable in an annuitant's gross estate?

Yes, although such combination contracts are uncommon in today's marketplace.

Even though an insured-annuitant holds no incidents of ownership in a life insurance policy at death, the proceeds of the policy nevertheless are includable in his or her gross estate under IRC Section 2039 as a payment under an annuity contract purchased by the insured-annuitant.[3]

In a case decided before IRC Section 2039 was enacted, the U.S. Supreme Court held that the proceeds were not includable in the insured-annuitant's gross estate under IRC Section 2036 as property transferred by the insured-annuitant in which he retained a right to income for life.[4]

If an insured-annuitant transfers a life insurance policy within three years before his or her death, the proceeds may be includable in the insured-annuitant's gross estate under IRC Section 2035 (Q 91).[5]

If an insured-annuitant owns a life insurance policy at death, the proceeds are includable in his or her gross estate either as property owned at the time of death[6] or as a payment under an annuity contract purchased by the insured-annuitant.[7]

549. If a decedent purchased an annuity on the life of another person, will the value of the contract be includable in his or her gross estate?

If a decedent purchased an annuity as a gift for another person and retained no interest in the annuity payments, incidents of ownership, or refunds, the value of the annuity ordinarily will not be includable in the decedent's gross estate (though a gift tax return may have been necessary to report the gift at the time).[8] See Q 698 for the rules pertaining to gifts of property (including annuities) made within 3 years of death.

If a decedent has named him or herself as refund beneficiary, the value of the refund may be taxable in the decedent's estate as a transfer intended to take effect at death.[9] This rule is not

1. IRC Sec. 2055.
2. Treas. Reg. §20.2055-2(b); *Choffin's Est. v. U.S.*, 222 F. Supp. 34 (S.D. Fla. 1963).
3. *Est. of Montgomery v. Comm.*, 56 TC 489 (1971), *aff'd* 458 F.2d 616 (5th Cir. 1972); *Sussman v. U.S.*, 76-1 USTC ¶13,126 (E.D.N.Y. 1975).
4. *Fidelity-Philadelphia Trust Co. v. Smith*, 356 U.S. 274 (1958).
5. *U.S. v. Tonkin*, 150 F.2d 531 (3d Cir. 1945).
6. IRC Sec. 2033; *Estate of Coaxum v. Comm.*, T.C. Memo. 2011-135 (2011).
7. IRC Sec. 2039.
8. See *Wishard v. U.S.*, 143 F.2d 704 (7th Cir. 1944).
9. IRC Sec. 2037(a).

applicable, however, unless the value of the refund exceeds 5 percent of the value of the annuity immediately before the donor's death. Moreover, if the donee-annuitant has the power to surrender the contract or to change the refund beneficiary, it would appear that such a power would preclude taxation in the donor's estate as a transfer to take effect at death.[1]

Where a decedent retains ownership of a contract until death, the value in the decedent's gross estate apparently would be the cost of a comparable contract at the time of the decedent's death. In one case, however, where a decedent and his wife paid one-half the cost of an annuity for their son, reserving to themselves the right to surrender the contract, only one-half the surrender value was included in the decedent's gross estate.[2]

550. If a person makes a gift of an annuity, will the value of any refund be includable in the donee-annuitant's estate?

If a donor irrevocably names one person to receive the income for life and irrevocably names another to receive the refund, the value of the refund at the donee-annuitant's death should not be includable in the donee-annuitant's gross estate. IRC Section 2039 is not applicable because the donee-annuitant is not the purchaser of the contract (Q 542).

However, if the refund is payable to the donee or the donee's estate (or the donee can otherwise direct where the refund goes), it will generally be included in the donee's estate for estate tax purposes.

551. If a decedent has been receiving payments under a private annuity, what is includable in the decedent's estate?

In the usual private annuity transaction (Q 526) where a decedent is the sole annuitant, the annuity payments cease at the decedent's death and nothing is left to be taxed in the estate. If benefits are payable to a survivor under the terms of a private annuity agreement, the value of the benefits is includable in the decedent's estate (Q 764). Survivor benefits paid to a surviving spouse under a joint and survivor annuity should qualify for the marital deduction, though.

If the transaction resulted in a gift from the annuitant to the obligor (Q 511), the annuitant's death within three years of the transaction may result in the value of the gift, plus gift tax paid, being included in the deceased annuitant's gross estate (Q 698). If an annuitant's death does not occur within three years, but the gift was a taxable gift, the gift will be an adjusted taxable gift for purposes of the estate tax computation in the annuitant's estate.

In the usual private annuity transaction, an annuitant's transfer of property given in exchange for the annuity is complete and absolute. Under such circumstances, no part of the transferred property is includable in the annuitant's estate. If, however, the annuitant retains at death an interest in the property transferred, the value of the property could be includable in

1. IRC Sec. 2037(b); see *Est. of Hofford v. Comm.*, 4 TC 542 (1945).
2. *Wishard v. U.S.*, supra.

the annuitant's gross estate under IRC Sections 2033, 2036, 2037 or 2038 as may be appropriate under the circumstances.

Nonqualified Employee Annuity

552. Is the value of a death benefit payable under a nonqualified employee annuity includable in an employee's gross estate?

Yes.

If an employee was receiving payments under the contract when he or she died, or if the employee would have had the right to receive payments had he or she lived, the value of the death benefit is includable in the employee's gross estate.[1] It is immaterial whether the employee's rights were forfeitable or nonforfeitable before death.[2] Premiums paid by the employer are considered as having been paid by the employee himself.[3] For tax sheltered annuities purchased for employees of tax-exempt organizations and public schools, see Q 553.

Tax Sheltered Annuity

553. Is a death or survivor benefit under a tax sheltered annuity includable in an employee's gross estate?

Estates of Decedents Dying After 1984

The value of an annuity or other payment receivable under a tax-sheltered annuity ("TSA") by the beneficiary of a deceased TSA annuitant is includable in the annuitant's estate under the rules discussed in Q 542 to Q 550. In reading those rules, remember that any contribution to the purchase of the annuity made by the decedent's employer or former employer is considered to be contributed by the decedent if made by reason of his or her employment.[4] Note that in the case of payments received as insurance on the life of a decedent (Q 3909), estate taxation is determined under the rules of IRC Section 2042 (Q 75 to Q 88), not under IRC Section 2039.

The Tax Reform Act of 1984 repealed the estate tax exclusion discussed below generally for estates of decedents dying after 1984. The repeal does not apply to the estate of any decedent who was a plan participant in pay status on December 31, 1984, and irrevocably elected the form of the benefit before July 18, 1984.[5] The Tax Reform Act of 1986 provided that these conditions are considered met if the decedent separated from service before January 1, 1985, and does not change the form of benefit before death.[6]

1. IRC Sec. 2039(a).
2. Treas. Reg. §20.2039-1.
3. IRC Sec. 2039(b). *All v. McCobb*, 321 F.2d 633 (2d Cir. 1963); *Est. of Bahen v. Comm.*, 305 F.2d 827 (Ct. Cl. 1962); *Est. of Wadewitz v. Comm.*, 39 TC 925 (1962), *aff'd*, 339 F.2d 980 (7th Cir. 1964).
4. IRC Sec. 2039(b).
5. TRA '84, Sec. 525.
6. TRA '86, Sec. 1852(e)(3).

Estates of Decedents Dying After 1953 and Before 1985

Unless an employer is an organization described in IRC Section 170(b)(1)(A)(ii) or (vi) or a religious organization, other than a trust, and is exempt under IRC Section 501(a), there is no estate tax exclusion for the death or survivor benefit.[1] These organizations, which frequently are referred to as "REC organizations" for religious, educational, and charitable organizations, include educational institutions other than public schools, churches, and charities that receive substantial support from a government or the general public. The IRS has taken the position that the exclusion does not apply to a contract purchased by an employer that is an integral part of a state or local government, such as a public school, college, university, or hospital.[2] The Tax Court, however, has held that the exclusion applied to contracts bought by a state university and a city board of education.[3]

If an employer is one of the eligible types, an estate tax exclusion is available provided the benefit is payable to some beneficiary other than an employee's estate. The exclusion applies only to amounts attributable to employer contributions, that is, to premiums that were excludable from the employee's gross income under the exclusion allowance rule (Q 3917) and to deductible employee contributions.

Any portion of premiums that were not excludable from an employee's gross income or were not deductible employee contributions are treated as employee contributions and a corresponding portion of the value of the death or survivor benefit is includable in the employee's gross estate.[4] For this purpose, any one-year term costs of pure life protection that were includable in the employee's gross income are treated as employee contributions.[5] The estate tax exclusion appears applicable whether payments are made in a single sum or in several payments. If a benefit is payable to an employee's estate, the entire value is includable in the employee's gross estate even though all premiums have come within the exclusion allowance.[6]

With respect to the estate of a decedent dying after 1982 and before 1985, the aggregate estate tax exclusion applicable to survivor benefits payable under a qualified plan (Q 3681 to Q 3740), a tax sheltered annuity, or an individual retirement plan (Q 3602) cannot exceed $100,000.[7] TRA '84 also amended TEFRA to provide that the $100,000 limit shall not apply to the estate of any decedent who was a plan participant on pay status on December 31, 1982, and who irrevocably elected the form of benefit before January 1, 1983.[8] The Tax Reform Act of 1986 provided that these conditions are considered met if the decedent separated from service before January 1, 1983, and does not change the form of benefit before death.[9] For estates of decedents dying before 1983, the exclusion (as described) is unlimited.

1. IRC Sec. 2039(c)(3).
2. Rev. Rul. 60-384, 1960-2 CB 172; Rev. Rul. 68-294, 1968-1 CB 46 (obsoleted by Rev. Rul. 95-71, 1995-2 CB 323).
3. *Est. of Johnson v. Comm.*, 56 TC 944 (1971), acq. 1973-2 CB 2 (followed in Let. Rul. 7817098); *Est. of Green v. Comm.*, 82 TC 843 (1984).
4. IRC Sec. 2039(c)(3).
5. Memorandum, 1967, Pension Plan Guide (CCH), Pre-1986 IRS Tax Releases, ¶17,337.
6. IRC Sec. 2039(c)(3).
7. IRC Sec. 2039(c), (g), as amended and added by TEFRA, and before repeal by TRA '84.
8. TRA '84, Sec. 525.
9. TRA '86, Sec. 1852(e)(3).

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The estate tax exclusion applies to the value of a death benefit receivable under a retirement annuity contract. Payments to a retirement fund by a REC organization will be regarded as the purchase of a retirement annuity contract for the organization's employee if the payments are made pursuant to a contractual arrangement between the organization and the custodian of the fund whereby the custodian of the fund is obligated to provide an annuity to the employee. Thus, if a state university makes payments under this kind of arrangement to a state retirement system on behalf of a professor employed by the university, the value of survivor benefits payable from the system following the professor's death is eligible for the estate tax exclusion in the professor's estate.[1]

Although it is clear that a tax-sheltered annuity may provide incidental life insurance protection (Q 3909), it is not entirely clear what the estate tax results will be where the death benefit consists of life insurance proceeds payable by reason of the insured's death prior to the maturity of the contract. A technical advice memorandum indicates that the term costs of life insurance protection, unlike the results under a qualified pension plan, will be treated as nondeductible employee contributions for estate tax purposes.[2]

The estate tax exclusion under IRC Section 2039(c) is applicable only to the estate of a decedent who was the employee and not to the estate of a non-employee beneficiary.[3] See Q 3659 for the estate tax exclusion applicable to amounts rolled over from a tax-sheltered annuity to an IRA.

Structured Settlements

554. What is a secondary market annuity?

Most secondary market annuities (also known as "factored" structured settlements) are annuities that were originally issued pursuant to structured settlements, meaning that the defendant in a lawsuit (often a personal injury suit) is found liable and, rather than pay damages to the plaintiff up front, reaches an agreement with the court so that the plaintiff receives the right to receive guaranteed annuity payments over time. In many cases, however, the plaintiff needs the funds immediately and, through a court-approved process, transfers the right to guaranteed payments under the annuity to a third-party buyer for a lump sum.

The court approval process is necessary because, while the plaintiff has received the right to income under the annuity, the defendant technically owns the annuity contract. Through this process, the parties enter into an assignment agreement that is presented to the court, which will approve or deny the transfer based upon whether it is in the transferring plaintiff's best interests.

It is important to note that failure to comply with this court approval process can result in imposition of a tax equal to 40 percent of the discount at which the product is sold.[4] In recent

1. Rev. Rul. 79-301, 1979-2 CB 327, obsoleted by Rev. Rul. 88-85, 1988-2 CB 333.
2. Memorandum, 1967, Pension Plan Guide (CCH), Pre-1986 IRS Tax Releases, ¶17,337.
3. *Est. of Kleemeier v. Comm.*, 58 TC 241 (1972).
4. IRC Sec. 5891.

years, however, nearly all states have developed a standardized process that has made obtaining court approval much more simple.

A secondary market annuity is often able to provide the client with a higher than average interest rate because the selling plaintiff typically must sell his income rights at a discount. The interest paid out under the contract, however, is governed by the original contract terms, which may provide for a rate that is much higher than today's market averages.

Because interest rates on guaranteed financial products have remained relatively low despite recent market success, these products, which are typically issued by large and well-known insurance companies, are often attractive to clients who are otherwise wary of locking themselves into a low interest rate.

Further, secondary market annuities have only recently become widely available to individual clients—prior to the financial crisis of 2008 and 2009, these products were most commonly purchased by large, institutional investors. New economic conditions, coupled with the newly streamlined court approval process, have opened the door for everyday individuals to invest in the secondary market for annuities.

555. What is a structured settlement?

A structured settlement is a settlement of a lawsuit that calls for periodic payments to be made over time, rather than as a lump sum. Structured settlements are common in tort actions (usually personal injury lawsuits) where the amount of the judgment can be particularly large.

Structured settlements are typically employed where either the financial position of the defendant requires that payments be spread over time or the plaintiff prefers to receive steady income over time, rather than a lump sum. The defendant may also prefer a structured settlement because the present dollar value needed to fund a stream of settlement payments into the future will be smaller than that which would be required with a lump sum payment.

556. Why might the parties to a judgment prefer to use a structured settlement rather than a lump sum payment?

The parties to a lawsuit have substantial flexibility in composing the terms of a structured settlement. In some cases, a structured settlement may be paid in equal installments over a set period of time, while in other cases a larger up-front payment is made, followed by smaller payments over time. The parties can structure a settlement so that it includes a guaranteed number of payments (which may be preferable to ensure that the plaintiff's heirs are entitled to continue to receive payments should the plaintiff die) or so that it includes payments for the life of the plaintiff.

557. What are the tax consequences to the plaintiff who receives structured settlement funds?

If a structured settlement of a personal physical injury or sickness claim is properly planned, each payment will be tax-free to the recipient.

Usually, when the plaintiff in a personal injury lawsuit receives a settlement, the proceeds of that settlement are taken tax-free.[1] Despite this, if the payments are structured so that the plaintiff receives the settlement funds over time, the earnings on the settlement will be taxable to the plaintiff unless a "structured" settlement is created.[2]

The plaintiff may prefer to receive settlement payments over time. For example, although the plaintiff can invest a lump sum payment, earnings on that investment would be fully taxable. In contrast, if a structured settlement is used, any earnings on the settlement are not taxed.

Whether or not the earnings on the settlement amount will be taxed depends largely on how the parties to the lawsuit characterize the payments. For example, the Tax Court has concluded that portions of a settlement that were labeled by the parties as "interest" were taxable as ordinary income (the case did not specifically deal with structured settlements).[3] However, in the usual case, a structured settlement will avoid this result because it will not distinguish between amounts paid to satisfy the claim and amounts paid as interest (e.g., the settlement will require the defendant to pay $150,000 per year for ten years). As such, the entire amount of each payment will be treated as proceeds of the settlement and can be taken tax-free.

558. What are the tax consequences if a structured settlement is sold?

If a plaintiff who is receiving payments under a structured settlement enters into an agreement to sell his or her rights to the future payment stream, a 40 percent excise tax may be imposed upon the purchaser.[4] This type of sale is known as a structured settlement factoring transaction.

The 40 percent tax applies only to the "factoring discount." The factoring discount is defined as the amount in excess of a fraction, the numerator of which is the aggregate undiscounted amount of structured settlement payments being acquired and the denominator of which is the total amount actually paid by the purchaser to the plaintiff who is selling his or her payment rights.[5]

The 40 percent tax does not apply if the sale of the structured settlement payment rights is approved in advance by a court order, which can result if the court finds that the sale is in the best interest of the plaintiff (as, for example, if the plaintiff needs the purchase price to pay his or her medical expenses or support dependents).[6]

559. When is a defendant who is a party to a structured settlement entitled to deduct the payments made pursuant to the agreement?

A payor who uses the cash receipts and disbursement method of accounting can deduct qualified payments made pursuant to a structured settlement in the year they are paid.[7]

1. IRC Sec. 104(a).
2. IRC Sec. 104(a)(2).
3. *Kovacs v. Commissioner*, 100 TC 124 (1993).
4. IRC Sec. 5891.
5. IRC Secs. 5891(a), 5891(c)(4)
6. IRC Sec. 5891(b).
7. Treas. Reg. §1.461-1(a)(1).

If the payor uses the accrual method of accounting, he or she can deduct any allowable expenses in the year in which: (1) all events that prove liability have occurred, (2) the amount of the liability can be determined with reasonable accuracy and (3) the economic performance requirement has been met with respect to the liability.[1]

In the context of a structured settlement, economic performance by the defendant will typically occur as the defendant actually makes the required payments to the plaintiff.[2]

For example, assume that the parties to a lawsuit enter into a structured settlement that requires the defendant to pay $150,000 per year to the plaintiff for ten years, and the defendant immediately purchases an annuity to provide for the entire $1.5 million obligation. Economic performance occurs when each $150,000 payment is made to the plaintiff—*not* when the defendant purchases the annuity. Therefore, assuming all other requirements are met, the defendant is entitled to deduct $150,000 for each of the ten years in which payment to the plaintiff is properly made under the structured settlement.

560. Is a defendant entitled to deduct amounts paid under a structured settlement if the underlying liability is contested?

Typically, an accrual basis taxpayer is not entitled to deduct amounts paid under a structured settlement unless all events that give rise to the liability have already occurred.[3] However, if the economic performance requirement has been met (see Q 559), an accrual basis taxpayer may be entitled to deduct amounts paid pursuant to a settlement in the year in which those amounts are paid if the following requirements are met:

(1) the liability has been asserted and the defendant contests it,

(2) the defendant transfers money or property to satisfy the asserted liability,

(3) the contest with respect to the asserted liability exists after the money or property is transferred, and

(4) but for the fact that the asserted liability is contested, the defendant would be allowed a deduction in the year when the transfer took place (or an earlier year).[4]

The money or property does not have to be transferred directly to the plaintiff in order for the defendant to claim the deduction. The transfer requirement can be met if the defendant transfers the money or property to an escrow agent or trustee that is later required to deliver the money or property pursuant to the settlement, or to the court that has jurisdiction over the case.[5] However, if the transfer is not made directly to the plaintiff and is instead made to an escrow account, trust or court, the transfer must discharge the defendant's liability to the plaintiff in

1. Treas. Reg. §1.461-1(a)(2).
2. IRC Sec. 461(h).
3. Treas. Reg. §1.461-1(a)(2).
4. IRC Sec. 461(f), Treas. Reg. §1.461-2(a)(1).
5. Treas. Reg. §1.461-2(c).

order for the economic performance requirement to be met.[1] The transfer must take the funds out of the defendant's control in order for the deduction to be allowed.[2]

If a defendant deducts amounts paid to satisfy a contested liability and these amounts are later refunded (for example, because the defendant is found not to be liable for the plaintiff's injuries), the defendant must include those amounts in gross income in the year they are refunded.[3]

561. What is a designated settlement fund?

A designated settlement fund (DSF) is a fund that is established pursuant to a court order to completely extinguish a defendant's liability with respect to a claim for personal injury, death or property damage.[4]

A DSF must also meet the following requirements: (1) no amounts may be transferred to it except in the form of "qualified payments," (2) it must be administered by persons, a majority of which are independent from the defendant transferring the claim, (3) it must be established for the purpose of resolving and satisfying claims against the defendant (or related persons) for claims arising out of personal injury, death or property damage, (4) the defendant (and related persons) may not hold any beneficial interest in the income or corpus of the fund, and (5) the defendant must make an election to treat the fund as a DSF.[5]

A "qualified payment" is a payment made to a DSF pursuant to a court order other than payments that (1) may be transferred back to the defendant (or a related person) or (2) are transfers of stock or indebtedness of the defendant (or any related person).[6] Once a defendant has made the election to treat a fund as a DSF, it is revocable only with the consent of the Secretary of the Treasury.[7]

562. What is a qualified settlement fund?

A qualified settlement fund (QSF) is a type of designated settlement fund (DSF) that was developed in order to expand the use of DSFs in satisfying payment obligations under structured settlements. Unlike DSFs, QSFs can be used to facilitate the settlement of claims that do not involve personal injury or sickness. In order to qualify as a QSF, the following requirements apply:

(1) the QSF must be established pursuant to a governmental order (such as a court order or order of a state or the federal government) and must be subject to the continuing jurisdiction of that government entity,

1. Treas. Reg. §1.461-2(e)(2)(ii).
2. See Treas. Reg. §1.461-2(c)(1)(ii).
3. Treas. Reg. §§1.461-2(a)(3), 1.111-1.
4. IRC Sec. 468B.
5. IRC Sec. 468B(d)(2).
6. IRC Sec. 468B(d)(1).
7. IRC Sec. 468B(d)(2)

(2) it must be established to resolve a claim (whether contested or uncontested) arising under (a) the Comprehensive Environmental Response, Compensation and Liability Act of 1980, (b) arising out of a tort, breach of contract, or violation of law or (c) designated by the Commissioner in a revenue ruling or revenue procedure, and

(3) the fund must be a trust under state law, or the assets must otherwise be segregated from other assets of the defendant-transferor (and related persons).[1]

QSFs are also subject to certain limitations on the types of litigation claims they can be used to satisfy. For example, if the liability arises under workers' compensation act or self-insured health plan, it may not be settled through a QSF.[2]

563. What are the tax consequences of using a designated settlement fund or qualified settlement fund to satisfy a defendant's obligations under a structured settlement?

Because of the economic performance requirement of IRC Section 461, payments made to a designated settlement fund (DSF) arguably may not be deductible by the defendant because the plaintiff has not actually received the funds transferred into the account. Despite this, Section 468B provides an exception and allows a defendant to deduct "qualified payments" made to a DSF.[3] Qualified settlement funds (QSFs) receive the same tax treatment as DSFs pursuant to the regulations under Section 468B.

A "qualified payment" is a payment made to a DSF or QSF pursuant to a court order other than payments that (1) may be transferred back to the defendant (or a related person), meaning that the transfer must be irrevocable, or (2) are transfers of stock or indebtedness of the defendant (or any related person).[4]

If the fund is a DSF or QSF that meets the requirements of Section 468B, the economic performance requirement will be considered met upon transfer to the DSF or QSF so that the defendant will be entitled to a deduction as payments are transferred into the fund regardless of when they are eventually paid to the plaintiff.

The gross income of DSFs and QSFs is taxed at the maximum tax rate applicable to trusts.[5] Qualified payments (see above) made to the fund are not considered income to the fund.[6] DSFs and QSFs are not subject to additional taxes, such as the alternative minimum tax, the accumulated earnings tax, the personal holding company tax or the capital gains tax.[7]

1. Treas. Reg. §1.468B-1.
2. Treas. Reg. §1.468B-1(g).
3. IRC 468B(a).
4. IRC Sec. 468B(d)(1).
5. IRC Sec. 468B(b)(1), Treas. Reg. §1.468B-2.
6. IRC Sec. 468B(b)(3).
7. Treas. Reg. §1.468B-2(g)

564. Can a defendant who is making payments under a structured settlement agreement assign responsibility for payments to a third party? What are the tax consequences of such an assignment?

The defendant-payor under a structured settlement can assign responsibility to provide future payments to the plaintiff who is receiving payments under the settlement if the settlement was negotiated to compensate the plaintiff for personal physical injuries or sickness.[1] If the assignment is a "qualified assignment," (see below) the assignee is not taxed on any amounts received from the defendant except to the extent that these amounts exceed the cost of any "qualified funding asset."[2]

A "qualified assignment" is defined as the assignment of a defendant's responsibility to make periodic payments as damages for a plaintiff's personal injury or sickness if the following requirements are met:

(1) the assignee is assuming liability from a party to the original lawsuit or settlement agreement,

(2) the periodic payments are fixed and determinable as to the amount and time of payment,

(3) the recipient of the payments does not have the right to accelerate, defer, increase or decrease the payments,

(4) the assignee's obligations under the structured settlement are no greater than the obligations of the person assigning the liability, and

(5) the periodic payments that the plaintiff receives under the structured settlement are excludable from the plaintiff's gross income under IRC Section 104.[3]

If the assignment satisfies the IRC requirements for a qualified assignment, any amounts that the defendant pays to the assignee who assumes payment obligations under the structured settlement will be tax-free to the assignee unless these amounts exceed the cost of purchasing a qualified funding asset (see below). If the cost of purchasing the qualified funding asset is less than the total amount that the assignee receives as consideration for assuming the settlement obligations, the difference must be included in the gross income of the assignee in the year in which the assignment took place.

A "qualified funding asset" is defined in the Code as an annuity contract used by the assignee to fund the periodic payments he or she has assumed under the structured settlement that meets the following requirements:

(1) the payment periods provided under the annuity are reasonably related to the periodic payments under the structured settlement (and the amounts of the annuity payments do not exceed the amounts to be paid under the structured settlement),

1. IRC Sec. 130(c).
2. IRC Sec. 130(a).
3. IRC Sec. 130(c).

(2) the annuity contract is designated as an obligation purchased to satisfy the terms of the structured settlement, and

(3) the annuity contract must be purchased not more than 60 days before the assignment and not more than 60 days after the assignment.[1]

The basis of the qualified funding asset will be reduced by any amounts that the assignee is able to exclude from gross income. If the assignee later sells the annuity contract used to fund payments, any gain realized on the sale is taxed as ordinary income to the assignee.[2]

565. Can a designated settlement fund (DSF) or qualified settlement fund (QSF) make a qualified assignment of its obligations to make periodic payments under a structured settlement?

Yes. If the DSF or QSF meets certain requirements, it can make a qualified assignment (see Q 563) of its obligations under a structured settlement. In order for an assignment of a defendant's obligations under a structured settlement to constitute a "qualified assignment" for tax purposes, the IRC requires that the assignee assume the liability from an original party to the lawsuit or agreement.[3] The IRS has provided the following guidance for determining when a DSF or QSF can be treated as an original party for purposes of Section 130(c):

(1) the plaintiff receiving periodic payments under the structured settlement must agree to the assignment by the DSF or QSF in writing,

(2) the assignment must relate to a claim for personal physical injury or sickness and either (a) the claim is being satisfied under a DSF established pursuant to a court order that completely extinguishes the defendant's tort liability with respect to the claim or (b) the claim is being satisfied under a QSF established to resolve or satisfy liability (whether contested or uncontested) that resulted from an event that has already occurred and given rise to at least one claim asserting liability,

(3) each qualified funding asset (see Q 564) purchased by the assignee in connection with the assignment by the DSF or QSF relates to a liability to a single plaintiff to make periodic payments for damages,

(4) the assignee is not related to the defendant who transferred the claim to the DSF or QSF, and

(5) the assignee does not control the DSF or QSF.[4]

In addition to these requirements, the DSF or QSF must continue to satisfy all other requirements of IRC Section 130 in order for the assignment to be qualified.

1. IRC Sec. 130(d).
2. IRC Sec. 130(b).
3. IRC Sec. 130(c).
4. Rev. Proc. 93-34, 1993-28 IRB 49.