1. **01 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. 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]](#footnote-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]](#footnote-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]](#footnote-3)

**408.01 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.

**487.01 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]](#footnote-4) In recent 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.

**408.02 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.

**408.03 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.

1. *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% x 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.
2. *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
3. *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.

**425.01 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.

**430.01 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.

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).

**404.01 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 404.02 ) 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.

**404.02 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 404.01)), 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.

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.

**453.01 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 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 8559-Q 8573) 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.

1. IRC Sec. 817(h). [↑](#footnote-ref-1)
2. Treas. Reg. §1.72-2(b)(3). [↑](#footnote-ref-2)
3. IRC Sec. 72(b)(2). [↑](#footnote-ref-3)
4. IRC Sec. 5891. [↑](#footnote-ref-4)