**THE TAXATION OF FIXED ANNUITIES**

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 time 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.

**How are fixed 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.

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.

The exclusion ratio of an individual whose annuity starting date 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. 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 bears to the total expected cumulative return payments (known in this case as the “expected return”) 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).

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.

**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. 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.

**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.

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

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.

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| **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% 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.    *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. |

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| **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).    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”).    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.    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. Any un-repaid policy loans must be subtracted from gross premiums in determining the investment in the contract for purposes of the exclusion ratio.    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.    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 . 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. (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).    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. If the contract has been purchased from a previous owner, the investment in the contract is the consideration paid by the purchaser. 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. |

**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. 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.

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.