Are Annuities Right for Your Clients

As the baby boom generation continues to age and the American economy continues to undergo structural change, planners need to be aware of the implications even when their clients refuse to be. For example:

* **The era of defined benefit plans is drawing to a close.** Fewer and fewer non-governmental employers are offering defined benefit plans, and those that still do are engaged, as likely as not, in trying to relieve themselves of their obligations, even if it requires declaring bankruptcy (as recently with Delta Airlines and Delphi, the auto parts supplier). Many of our parents could rely on a pension to provide them with a stream of income for the rest of their lives after retirement. Few of us can say the same. An annuity may, under the right circumstances, be the closest acceptable substitute.
* **Defined contribution plans won't provide enough for baby boomers to retire comfortably.** . A survey (released February 2010) by Fidelity Investments found that the average 401(k) balance of all participants at year-end 2009 was $64,200. The data was based on 11 million workers’ retirement accounts held by Fidelity.  With life expectancies continually increasing, most 401(k) participants can expect to outlive their account balances. Under those circumstances, a vehicle that provides a stream of income one can't outlive may be highly desirable to a client.

How do these facts affect the effort to shape the best possible overall financial plan for each client? In some cases, they may mean that annuities are an appropriate component of a retirement portfolio calibrated to fit a client's goals and needs.

# Tradeoff: Three Key Properties

To determine whether annuities are right for a particular client, the planner has to assess the tradeoff among three of their critical properties:

* **Tax characteristics:** as with qualified plans, tax is deferred on contributions to annuities and their inside build-up is tax free. In addition, since annuities are funded with after-tax dollars, that portion of withdrawals that represents return on capital is excluded.
* **Income stream:** perhaps the most salient selling point of annuities is that they provide the annuitant with a stream of income for life. Unlike a qualified plan account, it is impossible for the annuitant to outlive the benefits of the annuity.

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* **Access to capital:** perhaps the most significant downside of annuities is that the annuitant loses access to the funding capital—obviously a problem if the client doesn't have that much capital to begin with, and a concern in case of emergency. Note that some issuers do permit limited withdrawals of principal even after the starting date.

Of course, each of these factors is going to play a role in virtually any client's overall plan.

# What Are Annuities?

Essentially, an annuity is a contract under which the promisor, usually an insurance company, agrees to pay the promisee a fixed amount periodically for life.  However, an annuity may be variable, the periodic payments related to the return on an underlying investment portfolio.  There may be a single payment for the annuity, or multiple payments spread out periodically over time.  The annuity may be immediate, in which case payments to the annuitant start immediately, or deferred, in which case they start at some later designated time.

For federal income tax purposes, what matters is the nature of the amounts received under an annuity. Section 72 of the Internal Revenue Code distinguishes "amounts received as an annuity" (§72 generally) and "amounts not received as an annuity" (§72(e). Amounts not received as an annuity include policy dividends, returns of premiums, payments in full discharge of the issuer's obligation under the contract which are in the nature of a refund of the consideration, lump sum payments upon surrender, redemption or maturity of the contract, and partial withdrawals from annuity contracts. This Current Comment is primarily concerned with amounts received as an annuity.

# Taxation of Amounts Received as Annuities: §72

The "General Rule"

The general rule for taxation of annuities is stated in §72(a):

Except as otherwise provided in this chapter, gross income includes any amount received as an annuity (whether for a period certain or during one or more lives) under an annuity, endowment, or life insurance contract.

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Starting Date

When an annuitant purchases an annuity, he designates a starting date on which payments under the annuity are first received, either immediately or in the future. For purposes of §72(a), the starting date is defined at §72(c)(4):

For purposes of this section , the annuity starting date in the case of any contract is the first day of the first period for which an amount is received as an annuity under the contract; except that if such date was before January 1, 1954, then the annuity starting date is January 1, 1954.

Exclusion Ratio

Under §72(a), "gross income includes any amount received as an annuity . . . under an annuity, endowment, or life insurance contract." To the extent such amounts represent a return of the investment in the annuity,  they must be excluded. Hence the idea of the exclusion ratio set forth in §72(b):

Gross income does not include that part of any amount received as an annuity under an annuity, endowment, or life insurance contract which bears the same ratio to such amount as the investment in the contract (as of the annuity starting date) bears to the expected return under the contract (as of such date).

"Investment in the contract" means premiums paid before the starting date minus excludable returns on the contract (see I.R.C. §72(e)(6)).

"Expected return" is the total anticipated annuity payments that will be received by an individual. 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 §72(c)(3)(B)). If payments are to continue for a life or lives, expected return is determined by multiplying the sum of one year's annuity payments by the life expectancy of the measuring life or lives using the life expectancy tables set forth at Treas. Reg 1.72-9.

Thus, the exclusion ratio can be calculated like this:

|  |  |
| --- | --- |
| Contract Investment in the Contract | = Exclusion Ratio |
| Expected Return |

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The exclusion ratio is determined at the time annuity payments first begin ("the annuity starting date") and is applied to each payment as follows:

|  |
| --- |
|   Exclusion Ratio x Annuity Payment = Amount Excluded From Taxable Income |

The amount excluded from taxable income represents the portion of the annuity payment that is considered a return of capital. The remaining portion of the payment represents the interest element and is taxable.

To take a very simple example, consider an individual aged 61 who purchased an immediate life annuity at some point after June 30, 1986 for a single premium of $55,680, with annuity payments totaling $4000 per year. The individual must use Table V to figure his exclusion ratio. According to Table V, his life expectancy is 23.3 years. His exclusion ratio equals the investment in the contract ($55,680) divided by the expected return ($4,000 x 23.3, or $93,200), which equals .597. The amount of each payment exempt from tax equals the exclusion ratio (.597) multiplied by the annual payments ($4,000), which is $2,388. The balance of the payment received each year ($1,612) is taxable income.

Pre- and Post-December 31, 1986 Treatment of Exclusion Ratio

If an annuity's starting date is after December 31, 1986, the above procedure applies only until the total amount excluded equals the investment in the contract. §72(b)(2). After that, the full amount of each annuity payment is included in gross income. If the annuitant dies before recovering the investment in the contract, the unrecovered investment is deductible on the annuitant's last income tax return.

The situation is reversed for an annuity whose starting date is before December 31, 1986. The exclusion ratio remains constant throughout the annuitant's lifetime. An annuitant who outlives his or her life expectancy will continue to exclude a portion of each payment from gross income even after recovering the full investment in the contract. Conversely, no deduction is allowed for the unrecovered investment of an annuitant who dies before recovering the investment in the contract.

Exceptions: Non-natural Persons, Post-Death Distribution Rules

Under §72(u), a contract is not treated as an annuity if it is held by a non-natural person. Under §72(s), it is not treated as an annuity unless it provides for post-death distributions essentially according to the rules for qualified plans.

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Except for annuities purchased and funded before October 21, 1979, there is no step-up in basis for inherited annuities [Rev. Rul. 79-335; PLR 200439016]. [[1](http://nationalunderwriteradvancedmarkets.com/articles/fc060110-d.aspx?action=16#fn1)]

# Other Types of Annuities

This discussion of the basic rules of annuity taxation has assumed that we're concerned with an annuity paying a fixed amount to a single individual either for a period certain or for life. Other kinds of annuities are also subject to the general rule of §72(a), but with variations appropriate to their structure. For discussions of the tax treatment of annuities with a refund feature or period certain guarantee, so-called temporary life annuities, and joint and survivor annuities structured in various ways (level payment, survivorship annuities, and so on).

Variable Annuities

Unlike fixed annuities, variable annuities provide periodic payments in varying amounts, tied to returns on the underlying investment portfolio. The better the return, the higher the payment, and contrariwise. This means there is no way to calculate an expected return, as with fixed annuities, and thus no way to calculate an exclusion ratio.  Instead, the amount to be excluded from each payment is calculated by dividing the total investment in the contract to be recovered by the total number of annuity payments expected over the life of the contract.  That number is determined, in turn, by applying the relevant life expectancy table, using the annuitant's age nearest the annuity starting date.

To take a very simple example, consider an annuitant whose premium payments for a variable annuity total $100,000, who will collect payments from the annuity annually, and whose life expectancy, as measured by the relevant table for his age nearest the starting date, is 20 years. Dividing $100,000 by 20, we see that the annuitant can exclude $5000 from each annual payment. (If the payments were, say, quarterly, then we would divide $100,000 by 80, getting the correct result, $1250 excludible per payment.) If the annuitant receives a distribution of $10,000 from the annuity in 2009, he will include $5000 of that amount in income. If underlying returns are poorer in 2010 and the distribution is only $6000, then just $1000 will be included in income.

Variable Annuity Payments Below the Exclusion Amount

But what if the underlying investments perform so badly that the amount distributed is smaller than the amount to be excluded, so that less than the investment in the contract is recovered in a given payment period? Then the amount not recovered can be carried

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forward to future years, by dividing that amount by the annuitant's remaining life expectancy as of the succeeding year, and adding the result to the exclusion amount already determined for all future years. See Reg. §1.72-4(d)(3).

For example, consider A, who has a variable annuity contract for which she paid $25,000. Using the appropriate Annuity Table, it was determined that her life expectancy was 20 years as of the annuity starting date, and the annual exclusion amount was, therefore, $1,250. In the fourth year of annuity payments, the total received was only $450, or $800 less than the annual exclusion amount. This $800 shortfall is then divided by A's remaining life expectancy, as of the beginning of the following year. Assuming that A's remaining life expectancy at this point is 16 years, the $800 recovery shortfall is divided by 16, and the resulting amount, $50, is added to the previous exclusion amount ($1,250) increasing the exclusion amount for future years to $1,300.

# Certain Amounts Not Received As Annuities

Dividends

Dividends received before the annuity starting date that were excluded from gross income represent return of capital, and since they reduce total investment in the contract, the effect is to lessen the tax-exempt fraction of the guaranteed annual payment. Moreover, they are treated as amounts not received as annuities. [I.R.C. §72(e)(1)(B); Reg. §1.72-11(b)(1)]. On the other hand dividends left on deposit as of the annuity starting date become part of the investment in the contract (the numerator of the exclusion ratio). [I.R.C. §72(e)(1)(A); Reg. §1.72-11(b)(2)]

Lump Sum Withdrawals

Some contracts allow for a lump sum withdrawal (for example, in the event of an unforeseen financial emergency), coupled with a reduction in either the amount or the duration of the future periodic annuity payments, even after the annuity starting date. The tax effects of these two possibilities (different duration or reduced amount) on the stream of payments are as follows. (Note that the lump sum withdrawal itself is an "amount not received as an annuity," and thus is taxable under the rules set forth in §72(e).)

If an annuity is modified after the first payment, and the new annuity has a different duration, the general rule applies but the recipient takes a new start. The annuity starting date, investment in the contract, and expected return are all recomputed [Reg. §1.72-11(e)].

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If an annuitant withdraws a lump sum, and takes a reduced annuity with the same duration as the old one, he or she continues to use both the general rule and the old exclusion ratio (total investment divided by expected return). The actual excludable amount is reduced proportionately. The part of the lump sum excludable from gross income bears the same ratio to the unrecovered investment as the annuity payment bears to the original payment [Reg. §1.72-11(f)].

# Penalty for Premature Withdrawal

Annuities resemble other tax-favored vehicles in that the Code imposes a 10 percent penalty for withdrawals before the annuitant attains the age of 59 1/2. Indeed, §72(q)(1) provides: "If any taxpayer receives any amount under an annuity contract, the taxpayer's tax under this chapter for the taxable year in which such amount is received shall be increased by an amount equal to 10 percent of the portion of such amount which is includible in gross income." Thus, being 59 1/2 or older is one of the exceptions to this general rule set forth at §72(q)(2) (I.R.C. §72(q)(2)(A)).

# When Are Annuities Appropriate in Retirement Planning?

As a general rule advisers will only recommend the purchase of an annuity after a client has contributed the maximum to all the qualified tax-advantaged accounts (401(k)s, IRAs, Roth IRAs, and so on) he or she can establish. For one thing, annuity premium payments are not deductible, unlike contributions to a 401(k) or an IRA; and distributions and withdrawals, except to the extent of recovery of investment on the contract, are taxed as ordinary income, unlike a Roth IRA. But what if one has maxed out one's contributions, does not have a 401(k) available through an employer, or is disqualified by income from contributing to a Roth IRA? Are annuities an alternative worth considering to a taxable account such as a mutual fund?

Some think not. Even in this case, they say, annuities have disadvantages such as being more expensive than taxable funds, being illiquid, and offering gains that, when withdrawn, are taxed as ordinary income. These objections are sometimes well taken. However, there's an answer to each of them. Annuities may be more expensive, but part of the expense goes to the insurance protection an annuity provides; annuities are illiquid, but they provide income for life; annuity withdrawals are taxed as ordinary income, but those withdrawals, like withdrawals from a tax-favored account, provide income for retirement.

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The bottom line? It's the planner's responsibility to analyze each client's situation. The first consideration is the tradeoff mentioned at the beginning of this Current Comment: between the tax characteristics (deferral and partial exclusion) and the guarantee of a lifetime income stream, on the one hand, and the need to relinquish control of a chunk of capital.  Are the first two features worth it, for a particular client in a particular situation? As noted at the beginning of this Current Comment, our pension system is falling apart. This fact amplifies the lifetime-income feature of annuities and suggest that annuities can play an important role in retirement planning, particularly for high net worth individuals who have already maxed out on qualified plan contributions and whose current expenses (and unforeseen emergencies) are easily handled by other available funds.

Other Factors

Asset Protection

Since they are issued by insurance companies, in many states annuities share the protection from seizure by creditors that life insurance policies generally enjoy. See generally Section 19.5 of this Service, and specifically Section 19.5, Subdivision B, which contains a digest of state insurance exemption laws.

Estate Planning

The individual can designate a beneficiary, who takes possession of the annuity assets upon the individual's death without passing through probate.

As a Bond Alternative

In offering a guaranteed return that is lower than the return one would expect on the same amount invested in equities, annuities resemble bonds.  Instead of substituting for a full-blown pension, then, perhaps annuities could substitute for the bond component of a well-balanced portfolio. The tax and non-tax advantages of annuities over bonds make this a sound idea in appropriate cases, although interest rates should be compared with those of tax-free municipal bonds.

To Extend a Portfolio's Viability

Annuities can, then serve to help balance a portfolio. More than that, they can also help extend it. Studies in the last 10 to 15 years showed that a retiree could safely withdraw 4 percent per year from a retirement portfolio and expect it to last for 30 years. That 4 percent figure is now widely accepted as a planning target. More recent studies indicate

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that partly annuitized portfolios (up to 50%) can be expected to last up to 40 years at the same withdrawal rate. [See research by William Bengen, a financial planner in El Cajon, Cal.]

While there isn't a great deal of research in this area (most analysts devote their time to the question of accumulating capital, not drawing it down) this is fertile ground for study. Expect to hear a lot more on "safe" withdrawal rates and concomitant interest in the next generation of annuities and retirement income products.

[[1](http://nationalunderwriteradvancedmarkets.com/articles/fc060110-d.aspx?action=16#bfn1)] In general, under I.R.C. § 1014(a)(1), the basis of "property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent" is "the fair market value of the property at the date of the decedent's death." Section 1014(b)(9) of the Code provides, in the case of persons dying after December 31, 1953, that property acquired from the decedent by reason of death, form of ownership, or other conditions (if by reason thereof the property is required to be included in determining the value of the decedent's gross estate) shall, for purposes of section 1014(a), be considered to have been acquired from or to have passed from the decedent. Section 1041(b)(9)(A), however, excludes "annuities described in section 72" from this treatment. Thus, a beneficiary who inherits a deferred annuity receives it on a carryover basis from the decedent, and payments under the annuity may constitute income subject to various rules, including Code Section 691, under which the beneficiary may be entitled to a deduction for estate tax paid.

When an annuitant dies before the annuity starting date, the contract typically provides a "death benefit." The beneficiary can typically elect to receive this amount in a lump sum, as the annuitant could have before death. But the tax situation in this instance is not entirely parallel to that post-annuitization. A 1970 Revenue Ruling (Rev. Rul. 70-143, 1970-1 C.B. 167) held that a such a lump sum payment to a beneficiary before the starting date is not, under relevant regulations, an annuity and therefore not excluded from a basis step-up by Section 72. Rev. Rul. 70-143 was prospectively revoked by Rev. Rul. 79-335 (1979-2 C.B. 292), effective October 21, 1979, but annuities purchased and funded before that date still receive a step-up, contrary to the general rule.