Six things you need to know about the Taxation of Deferred Annuities

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.

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..

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.

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).

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. The annuity payments (whether life income or installment) are taxed under the regular annuity rule 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.

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.

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. 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).

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]](http://pro.nuco.com/taxfacts2015/tfins/p1-anns/death/Pages/0516-00-TF1.aspx?k=deferred+annuity#_ftn2) 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]](http://pro.nuco.com/taxfacts2015/tfins/p1-anns/death/Pages/0516-00-TF1.aspx?k=deferred+annuity#_ftn3)

**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. The periodic payments then will be taxable to the beneficiary under the regular annuity rules. The exclusion ratio for the contract will be based on the decedent’s investment in the contract and the beneficiary’s expected return.

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 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 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 mistaken 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”. 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. 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.[[7]](http://pro.nuco.com/taxfacts2015/tfins/p1-anns/death/Pages/0516-00-TF1.aspx?k=deferred+annuity#_ftn7) Although the aforementioned step-up in basis treatment for pre-October 21, 1979 annuities has only been directly ruled on in the case of a variable annuity, it also would theoretically apply to fixed annuities issued prior to October 21, 1979.

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. 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 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).

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. 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).

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.