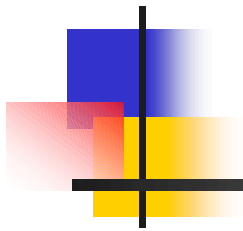


# INCOME TAXATION OF COMMERCIAL ANNUITIES



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# Parties to the Annuity Contract.



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1. The annuity company is the party that issues the policy and it must keep its promises.
2. The annuitant is the individual - and it must be a human – who forms the basis of the measuring life.
3. The beneficiary is the person who receives the benefit of the annuity contract.
4. The owner is the individual or entity that has the ownership rights in the contract.



# Annuity Tax Issues

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The tax rules associated with annuities are complex and not always entirely clear.

Two main areas of inquiry:

1. Payment during life; and
2. Annuity payments after the death of the annuitant.



# Annuity payments during the owner's life.

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- Fixed Annuities - Taxable amounts are determined by reference to the exclusion ratio which is the total amount invested in the contract divided by the expected return.
- Variable Annuities – As the expected return amount is unknown the expected return is deemed to be equal to the amount invested in the contract. Thus all principal is returned first then all other amounts received are deemed income.



# Taxation of Annuity!

## Points to remember!

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- Whose tax is it, anyway?

It must be remembered that the tax liability for payments from an annuity always remain with the owner, regardless to whom the payments are made, if the owner is living.

However, if the payments are made to the beneficiary because of the death of the owner, then the beneficiary is taxed on the payments.



# Payment after death in “Payout Status”

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- In this instance IRC section 72(s)(1)(A) requires that the annuity be paid out at least as rapidly as under the method being used on the date of death.

If the beneficiary receives a lump sum or in installments (other than payments calculated by application of a new annuity option) then proceeds are excludable from income by the beneficiary until the beneficiary receives the investment in the contract. All other income is taxable as ordinary income. Thus a FIFO (First In First Out) rule is used.



# Payment after death, Annuity not in "Payout Status"

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Here is a real trap for the unwary.  
Before we begin this discussion let us  
look at Code Section 72(s). **If you  
give any advice on annuities and  
don't understand what follows you  
can expect a catastrophe!**

# Internal Revenue Code Section

## 72(s)(1)

- **(s) REQUIRED DISTRIBUTIONS WHERE HOLDER DIES BEFORE ENTIRE INTEREST IS DISTRIBUTED**
  - **(1) IN GENERAL**
- **A contract shall not be treated as an annuity contract for purposes of this title unless it provides that--**
- **(A) if any holder of such contract dies on or after the annuity starting date and before the entire interest in such contract has been distributed, the remaining portion of such interest will be distributed at least as rapidly as under the method of distributions being used as of the date of his death, and**
- **(B) if any holder of such contract dies before the annuity starting date, the entire interest in such contract will be distributed within 5 years after the death of such holder.**



## Section 72(s)

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- As you will notice section 72(s)(1)(A) is the same general rule for annuities in payout status at the holder's death. The second rule, section 72(s)(1)(B) is the default rule for annuities not in payout status and applies unless an exception is available.
- Sections 72(s)(2) and (3) provide the two exceptions and neither exception is available unless the annuity is payable to a "designated beneficiary" as defined in section 72(s)(4) as "any individual designated a beneficiary by the holder of the contract."



## Section 72(s)

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- Section 72(s)(2) permits a designated beneficiary to take the proceeds over a period not longer than the beneficiary's life expectancy. Payouts are taxed based upon the exclusion ratio computed by dividing the annuitants remaining "investment in the contract" and the beneficiary's "expected return."
- Section 72(s)(2) also permits the use of the IRS "fractional method" of payment with a recalculation of life expectancy each year. This can result in a long deferral of income. Be aware of whether or not your policy allows for such payments.



## Section 72(s)

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- The second alternative to the five year rule only applies to a beneficiary who is a surviving spouse of the holder. Section 72(s)(3) permits the surviving spouse to treat the decedent's annuity as his or her own as if he or she were the owner from the inception. **Please note that this exception does not apply if the beneficiary is a trust to which the spouse is a beneficiary!**



# Section 72(h)

## A TRAP FOR THE UNWARY ADVISOR

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- **(h) OPTION TO RECEIVE ANNUITY IN LIEU OF LUMP SUM**
- **If--**
- **(1) a contract provides for payment of a lump sum in full discharge of an obligation under the contract, subject to an option to receive an annuity in lieu of such lump sum;**
- **(2) the option is exercised within 60 days after the day on which such lump sum first became payable; and**
- **(3) part or all of such lump sum would (but for this subsection) be includible in gross income by reason of subsection (e)(1),**
- **then, for purposes of this subtitle, no part of such lump sum shall be considered as includible in gross income at the time such lump sum first became payable.**



## Section 72(h)

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What does this mean?

If the contract allows the beneficiary to take the proceeds as an annuity, in lieu of a lump sum settlement, and such person makes an election to do so within sixty days of the owner's death, then the annuity will be taxed to the beneficiary under the regular annuity rules. If the election is not made within 60 days from the owner's death, then the proceeds are entirely taxable, to the extent they exceed the investment in the contract, in the year of the owner's death regardless of the method of distribution chosen by the beneficiary.



## Section 72(h)

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- There is a lot of argument over the real application of section 72(h) but the best advice is to simply be aware of the provision and make sure that the election is made within 60 days of the owner's death and thereby eliminate any potential problems.



# Jointly held annuities.

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- In general, and unless compelling reasons exist, annuities should not be held jointly.
- Why? Even though the asset passes automatically to the joint owner at the death of the co-owner, the payout rules and income tax consequences are dictated ***solely*** by the rules contained in Sections 72(s)(2) and (3).
- Moreover the spousal continuation rules of section 72(s)(3) will not apply if the surviving tenant is a spouse because the spouse must be a beneficiary and not an owner.
- Finally, if the annuity is owned by a husband and wife, and the beneficiary is their daughter, then, on the death of the first spouse, the daughter would be entitled to the proceeds of the annuity and not the spouse.
  
- Do not use jointly owned annuities!



# Distributions of Annuities in Trust

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- Types of trusts – Grantor, non-grantor, revocable, irrevocable, inter-vivos and testamentary.
- While many arguments have been made it appears that at least one line of thinking provides that when a trust is the beneficiary of an annuity there are only two distribution options.

# Trusts and Annuity Distributions



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- Annuity in “pay status”: If the annuity is in pay status then the distribution must meet the rules of section 72(s)(1) and the annuity must be distributed “at least as rapidly as under the method of distribution being used as of the date of his death.”

# Trusts and Annuity Distributions



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- Not in “pay status”: Under the Internal Revenue Code it appears that the only option available is that found in section 72(s)(1)(B) which requires a distribution within five years from the annuitant’s death.
- This is true regardless of who the beneficiary of the trust may be including a surviving spouse.

# Trusts and Annuity Distributions



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- A counter argument to the five year rule goes as follows:

One argument asserts that because Section 72(s)(2)(A), in defining when the annuitization option of section 72(s)(2)(B) will be permitted, requires only that the holder's interest be "payable to (***or for the benefit of***) a designated beneficiary", then, if the trust is acting as the "agent of a natural person," and if that natural person is the sole beneficiary of the trust, it follows that the trust is acting "for the benefit of" that "designated beneficiary" and should be able to take proceeds over a period not exceeding the life expectancy of that designated beneficiary, so long as payments commence within one year of death.



# Thanks for attending!

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Please take the time to fill out the evaluations. They are very important to us!

Ralph Minto, Jr.

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