M INTELLIGENCE

M FINANCIAL GROUP'S ANNUITY TAX FUNDAMENTALS

It is crucial that clients understand how annuity products are taxed so that realistic expectations can be established and effectively managed. Although annuity taxation can align with other types of investment accounts, in many cases it can vary greatly from investments such as a traditional nonqualified investment account. This M Financial Group annuity tax reference article defines and provides examples of annuity taxation referencing the various product types and account registration options available through M Financial.

QUALIFIED ANNUITIES

Qualified annuities, like other qualified plans or individual retirement accounts (IRAs), are fully taxable at the client's ordinary income tax bracket at the time income is received or a death benefit is paid out to a beneficiary. Income is taxed at the annuity contract owner's tax bracket while death benefits are taxed at the beneficiary's tax bracket. There is one caveat: if the beneficiary is the client's spouse, a spousal rollover is available. Most contracts offer spousal continuation provisions that allow the contract (and tax deferral) to continue in the spouse's name. A non-spouse beneficiary may opt to take an annuity death benefit as a lump sum or in distributions over a 10-year period to spread out the taxes owed[1].

ROTH IRA ANNUITIES

If prescribed ROTH guidelines are followed, ROTH IRA funds can be used to purchase an annuity. A client who makes such a purchase would receive any income taken tax free as the contributions were made from after-tax monies.

NONQUALIFIED ANNUITIES

Nonqualified annuity taxation differs from qualified annuity taxation discussed above. Tax consequences will vary based on factors like product category, income classification, and contract performance.

In general, nonqualified annuities are funded with after-tax monies, and any growth in the contract is tax-deferred until income is taken or the beneficiary receives a death benefit. Unlike qualified annuities which are fully taxable at ordinary income rates upon distribution (excluding nondeductible IRA contributions), a nonqualified annuity's cost basis (original after-tax investment amount) is not subject to income tax, while the portion of the contract that represents the account earnings is fully taxable as ordinary income upon receipt.

The information above is important to understanding how nonqualified annuity income is taxed, and it differs depending on how the income paid is construed.

NONQUALIFIED ANNUITY INCOME TAXATION VIA WITHDRAWAL

Withdrawals from nonqualified annuities are taxed using the LIFO method (last in, first out), meaning income would be fully taxable at ordinary income rates until the client had received cumulative income equaling the gains in the contract.

[1] For designated beneficiaries who meet certain criteria (e.g., minor children, the chronically ill or permanently disabled, or are not more than 10 years younger than the original IRA/annuity holder), distributions may be made on the beneficiaries' life expectancy for a period longer than 10 years.

Once gains are exhausted, the client would then receive tax-free income representing the cost basis (original investment) until cumulative income received equaled that original investment amount. If a guaranteed lifetime income rider is selected on the contract, what may be less apparent is that once the client has exhausted gains and basis via cumulative income, the income above the original basis is fully taxable. Figure 1 outlines net annuity income payments over 10 years via income paid by a lifetime income rider assuming a 0% rate of return. The account balance column represents the beginning-of-year account balance, with income coming out directly after the beginning of the year.

Figure 1: Net annuity income payments over 10 years

NET INCOME EXAMPLES WITH GAINS AND BASIS-0% RATE OF RETURN							
Payment Amount	Account Balance	Remaining Gains in Contract	Remaining Basis in Contract	Assumed Rate of Return	Assumed Tax Rate	Income Subject to Tax	Net Income Payment
$100,000	$600,000	$350,000	$250,000	0.00%	40%	$100,000	$60,000
$100,000	$500,000	$250,000	$250,000	0.00%	40%	$100,000	$60,000
$100,000	$400,000	$150,000	$250,000	0.00%	40%	$100,000	$60,000
$100,000	$300,000	$50,000	$250,000	0.00%	40%	$50,000	$80,000
$100,000	$200,000	$0	$200,000	0.00%	40%	$0	$100,000
$100,000	$100,000	$0	$100,000	0.00%	40%	$0	$100,000
$100,000	$0	$0	$0	0.00%	40%	$100,000	$60,000
$100,000	$0	$0	$0	0.00%	40%	$100,000	$60,000
$100,000	$0	$0	$0	0.00%	40%	$100,000	$60,000
$100,000	$0	$0	$0	0.00%	40%	$100,000	$60,000

Figure 2 takes the ledger presented in Figure 1 and applies a fluctuating rate of return to provide a more real-life example of annuity withdrawals. The example above does not show any further growth after the original gains in the contract are depleted. The example below, however, shows how gains accumulated while the contract value is paying income can affect taxable income and the resulting net income payment, assuming other inputs remain the same. As in Figure 1, the account balance column in Figure 2 represents the beginning of year account balance, with income distributed at the start of the year. After income is withdrawn, the account performs at the assumed rate of return, which results in the "Account Balance" value for the next contract year.

Figure 2: Net annuity income ledger applying a fluctuating rate of return

NET INCOME EXAMPLES WITH GAINS AND BASIS-FLUCTUATING RATES OF RETURN							
Payment Amount	Account Balance	Remaining Gains in Contract	Remaining Basis in Contract	Assumed Rate of Return	Assumed Tax Rate	Income Subject to Tax	Net Income Payment
$100,000	$600,000	$350,000	$250,000	5.00%	40%	$100,000	$60,000
$100,000	$525,000	$275,000	$250,000	10.00%	40%	$100,000	$60,000
$100,000	$467,500	$217,500	$250,000	5.00%	40%	$100,000	$60,000
$100,000	$385,875	$135,875	$250,000	10.00%	40%	$100,000	$60,000
$100,000	$314,463	$64,463	$250,000	5.00%	40%	$64,463	$74,215
$100,000	$225,186	$10,724	$214,462	10.00%	40%	$10,724	$95,711
$100,000	$137,704	$12,519	$125,185	5.00%	40%	$12,519	$94,993
$100,000	$39,589	$1,886	$37,703	10.00%	40%	$62,297	$75,081
$100,000	$0	$0	$0	0.00%	40%	$100,000	$60,000
$100,000	$0	$0	$0	0.00%	40%	$100,000	$60,000

NONQUALIFIED ANNUITY INCOME VIA ANNUITIZATION

Annuitization is the act of converting an annuity investment (hence, "deferred" annuity) into a series of periodic income payments, which can be for a specified period, or for the annuitant's lifetime. The insurance company receives the lump sum of capital, and makes calculations to determine an annuity payout amount. Key metrics for these calculations normally include the capital being annuitized, the annuitant's life expectancy, annuity payment option selected, and the projected performance of the insurance company's general account funding the annuity obligations.

Based on these calculations, the insurance company determines an exclusion ratio, which determines what portion of each annuity payment will be taxable as earnings, and what portion of each payment will be considered a tax-free return of basis. Annuitization options are available with fixed income annuities (single premium income annuities [SPIA] and single premium deferred annuities [SPDA]), and deferred fixed, indexed, or variable annuities. Once the contract's cost basis is exhausted via the exclusion ratio of cumulative payments, all distributions are then fully taxable as illustrated in Figure 3. The ledger shows 10 years of income of $100,000, with a contract that currently has $500,000 in basis, and a 70% exclusion ratio.

Figure 3: Annuity income taxation using annuitization

NET INCOME EXAMPLES FOR SPIA-$500K BASIS-70% EXCLUSION RATIO				
Payment Amount	Basis in Contract	Assumed Tax Rate	Income Subject to Tax	Net Income Payment
$100,000	$500,000	40%	$30,000	$88,000
$100,000	$430,000	40%	$30,000	$88,000
$100,000	$360,000	40%	$30,000	$88,000
$100,000	$290,000	40%	$30,000	$88,000
$100,000	$220,000	40%	$30,000	$88,000
$100,000	$150,000	40%	$30,000	$88,000
$100,000	$80,000	40%	$30,000	$88,000
$100,000	$10,000	40%	$90,000	$64,000
$100,000	$0	40%	$100,000	$60,000
$100,000	$0	40%	$100,000	$60,000

Nonqualified annuity death benefit taxation rules are fairly straightforward. As mentioned above, a nonqualified annuity's cost basis (original after-tax investment amount) is not subject to income tax, while the portion of the contract that represents the account earnings is fully taxable as ordinary income upon receipt.

Based on this information, if a client dies with an annuity account balance, their beneficiaries will receive the proceeds, and any portion of the contract value that represents the original basis will be received by the beneficiaries tax free. Any portion representing gains will be subject to their ordinary income tax bracket. A client's spouse can elect the spousal continuation option previously discussed to continue tax deferral on annuity proceeds. It is important to consult with the issuing carrier to determine what distribution options are available to both spousal and non-spousal beneficiaries on their specific contracts.

OTHER ANNUITY TAX CONSIDERATIONS

1. TAXATION OF CORPORATE-OWNED NONQUALIFIED ANNUITIES

Unlike other nonqualified investments, nonqualified annuities are not subject to long- and short-term capital gains rates. Instead, earnings are deferred and gains are taxed as ordinary income when withdrawals are taken from the contract. This deferral of gains can be an attractive feature of nonqualified annuities, but the owner needs to be a natural person to receive this deferral benefit. IRS rules state when a business entity owns an annuity, it loses its tax-deferred status and is subject to normal yearly income taxes based on policy gains. The tax ID of the corporation, partnership, or other entity would receive the 1099 each year.

2. TRUST-OWNED ANNUITIES

Nonqualified annuities have unique tax provisions that can allow for deferral of gains, unlike other nonqualified assets. For an annuity to receive this tax treatment, it typically needs to be owned by a natural person, as highlighted above. There is an exception to IRC Section 72(u)'s "natural person rule": if an annuity is held "by a trust as an agent for a natural person," it will still be eligible to receive the tax-deferral treatment. As a general matter, a trust is acting as an agent for a natural person where it is established by a natural person, and all beneficiaries are also natural persons.

3. NONQUALIFIED SPIAS AND THE PRE-59.5 IRS WITHDRAWAL PENALTY

With other nonqualified investments, withdrawals from an account prior to the account owner attaining age 59.5 will result in a 10% IRS penalty, unless an exception applies[2]. If the client is buying a SPIA (income starting within 12 months) using new money, IRC Sec. 72(q) carves out an exception for nonqualified immediate annuities. As there has essentially been no deferral period, no penalty would apply.

REMOVING AN ANNUITY FROM AN ESTATE-IRD

Income in Respect of a Decedent (IRD) is income that the decedent is entitled to, or has a future right to, which the decedent has yet to pay tax on. This would apply to immediate annuities with any type of period certain guarantee payout, where the annuitant dies before the period certain expires, as well as to deferred annuities that pay to beneficiaries upon death. Any future payments to heirs or a surviving spouse are still subject to income tax, and tax-deferred account balances are also included in the estate. This could create a double taxation situation for estates valued above the exemption amount[3].

SEEK EXPERT ADVICE

To connect and discuss any of the concepts covered in this article, please reach out to your advisor and/or tax professional for additional support or questions regarding this material.

[2] Complex rules exist for age pre 59.5 distributions from nonqualified annuities and qualified accounts. These rules are outside the scope of this piece, so please consult a qualified tax advisor.

[3] There is an income tax deduction available to a beneficiary taxpayer in these scenarios that is intended to help offset this double taxation issue. However, if the beneficiary taxpayer does not avail themselves of this deduction in any given year, they may have a larger gross tax liability.

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