TAX TREATMENT OF INCOME FROM AN ANNUITY

Factors to Consider When Selecting a Product to Support a Retirement Income Plan

by Jim Dobler

One significant benefit of purchasing an annuity is the favorable tax treatment you receive when investing or generating income with your assets. In fact, before the introduction of living benefit riders over the last 20 years, tax deferral and a death benefit were considered the primary selling features of these products. Today, both deferred and immediate annuities are being positioned as essential products for allocation within a client's portfolio to help optimize cash flow in retirement. Of course, taxes can have a dramatic impact on any cash flow plan regardless of where you place your assets. This article deals with the basic rules of taxation when taking income from an annuity.[1]

Deferred vs. Immediate Annuities

There are two time periods (i.e., phases) associated with any annuity contract: a) the deferral phase, where investments can grow on a tax-deferred basis and can be liquidated at some point in time given certain rules and restrictions, and b) the income phase – or annuitization phase – where the assets in the contract are converted into a lifetime stream of income[2] – similar to other sources of lifetime income such as a pension or Social Security. Income taken from a deferred annuity, such as a variable annuity or fixed index annuity, is typically taken in the form of a systematic withdrawal from the investment account(s) within the contract. Sometimes the level or amount of withdrawals can be guaranteed for a lifetime without having to annuitize the contract with the election of a living benefit rider – such as a guaranteed lifetime withdrawal benefit (GLWB). Alternatively, anyone wishing to purchase an annuitization guarantee based on today's interest rates and mortality factors will buy either an immediate income annuity (SPIA) or a deferred income annuity (DIA).

Qualified vs. Nonqualified Annuities

There are two tax classifications of an annuity: qualified and nonqualified. With a qualified annuity, all the deposits that are made into a contract are usually done with pretax dollars, similar to investing in other qualified products like a 401(k), 403(b), profit sharing plan or any other IRA. No taxes are paid on the assets as long as the money stays within the qualified product. However, anytime you take assets out, whether it is a lump sum or a systematic withdrawal, all of the monies received are fully taxable as ordinary income. In the case of annuities, the taxation as ordinary income from a qualified contract is the same regardless of whether it is taken during the deferral phase as a withdrawal or the annuitization phase as a payout.

Deposits into a nonqualified contract are usually made with funds that have already been taxed to the client. These funds are considered the principal and are called the “cost basis.” When the client takes money out of the contract, the cost basis (or principal) is the portion that is not subject to income tax. Beyond that there are some differences to consider between deferred and immediate annuities.

Nonqualified Immediate Annuities

When you buy a nonqualified income annuity, you give an insurance carrier money (the premium) in return for a stream of guaranteed income that will start within the next month to 12 months (a SPIA) or possibly deferred anywhere between two to 30 or more years (a DIA). Part of this income stream would be considered the cost basis and is not taxed, while the other portion, which is considered earnings, is taxed as ordinary income. The details are best expressed with an example.

Let’s take a 65-year-old male with $100,000 to deposit in the SPIA with five years certain. Today, this would provide him with an income stream of $585 per month or $7,020 per year.[3] The IRS estimates his life expectancy at 21.9 years, based on the Uniform Lifetime Table. To find how much is excluded from taxes (i.e., the exclusion ratio), we would take the $100,000 (cost basis) and divide it by $153,848 ($7,025 of annual income x 21.9 life expectancy), and get an “exclusion ratio” of 65.0%. The exclusion ratio is the portion of the income payment that the IRS considers as a return of the client’s principal and therefore is not subject to tax. In this case, that works out to having $4,566 of the $7,025 per year excluded from taxes and the client would have to pay ordinary income tax on the remaining $2,459 each year. Once the client recovers all of his cost basis (basically the original $100,000 after 21.9 years), then any income payment going forward will be fully taxed as ordinary income.

The same process would apply to a DIA, but because DIAs typically generate a higher payout amount in return for a delayed income start date, a larger portion would be taxable. For the same 65-year-old male with $100,000, the monthly income stream from a DIA with a 10-year income deferral would be $1,233 per month or $14,796 per year.3 At the age of 75, his life expectancy would be 13.9. Therefore, the amount that would be excluded from taxes would be $100,000 (cost basis) divided by $205,664 ($14,796 x 13.9). This would equate to an exclusion ratio of 48.6%. Again, once the cost basis is fully recovered over time, payments would then be 100% taxed as ordinary income.

Most of the annuitized income in the market today is received in a fixed amount. However, there are options available where the client can purchase an immediate variable annuity or receive variable annuitization. In these cases, the income amount received is dependent on the return within the variable subaccount during the annuitization phase, so payments will generally fluctuate from year to year. Since payments are not fixed, you would determine the exclusion ratio by taking the total number of payments expected during life expectancy (12 monthly payments x 21.9 years for the same 65-year-old male = 262.8 payments) and divide that number into the original investment or premium (e.g., $100,000). In this case, the exclusion of $381 per month (or $4,572 per year) ends up being close to the ratio under the fixed payment example above for a SPIA.

Nonqualified Deferred Annuities

Any withdrawals (or lump sums) taken from a deferred annuity (VA, FIA, or fixed) – during the deferral phase – would be taxed on a last-in, first-out (LIFO) or "earnings first" basis. This simply means that earnings are taxed first, as ordinary income, up to the amount of the withdrawal. At some point in the future, if withdrawals exceed earnings in the contract, then those additional withdrawal amounts are considered tax-free until the original investment (or premiums) has been depleted.

LIFO, or earnings-first, tax treatment of withdrawals would also apply if a GLWB (guaranteed lifetime withdrawal benefit) is in effect. However, if the account value were to ever hit $0 at some point in the future, any guaranteed withdrawal received at that point forward would be 100% taxable as ordinary income. This is because the insurance company is technically transitioning the contract into the annuitization phase to support the GLWB guarantee going forward with essentially a "premium of $0" coming from the client, resulting in an exclusion ratio of 0%.

If a client chooses to trigger the annuitization phase within a deferred annuity contract, the tax treatment would be similar to that of an immediate annuity through the use of an exclusion ratio. Recent tax law changes now allow for clients to partially annuitize their deferred annuity contract and enjoy the advantages of both the tax-free growth in a deferred account and exclusion ration treatment for the portion they choose to annuitize. This is referred to as splitting a deferred annuity. For example, let's say a client invested $100,000 into a deferred annuity that is now worth $200,000 and he wants to annuitize $100,000. Half the original cost basis, $50,000, would transfer over to a supplemental immediate annuity contract held by the same carrier and exclusion ration treatment would take effect. Eventually the client would still pay the same amount of tax, but is able to disperse the tax burden by not paying all the tax up front (via LIFO).

Overall, the tax treatment of income from an annuity is an important factor that should be taken into account when considering product options to support a retirement income plan. Other tax considerations would also apply with regard to death benefits and the impact on an estate plan. Ultimately, an advisor should be knowledgeable with the various tax consequences of using annuities before presenting them to a client.

1-Because annuity rules can change and are oftentimes complex, it is best to consult a tax professional when considering the tax impact associated with any type of annuity.

2-Subject to the claims-paying ability of the insurance company.

3-CANNEX Income Annuity Exchange, Average of Top 5 Results, October 1, 2013.

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