Annuities: Traps for the Unwary

Standard Tax Rules for Annuities

The taxation of annuities is straightforward. Income from the annuity contract is split between two categories: return of investment (basis) and earnings. *Basis* is not taxed; however, *earnings* are taxed. Further, earnings are taxed at ordinary income tax rates, rather than capital gains tax rates.

Annuities are subject to early withdrawal penalties, similar to other retirement accounts. Distributions from non-annuitized annuities taken before age 59 Â½ are subject to a 10 percent early withdrawal penalty tax, if those dollars are earnings rather than basis. However, early withdrawals from an annuity are taxed on a *last-in-first-out* (LIFO) basis, meaning all earnings must be exhausted before basis can be returned tax free.

An exception to LIFO taxation is the use of the exclusion ratio for annuitized payments received by annuitants. Instead of paying taxes on all earnings up front, annuitants can use the exclusion ratio to spread the taxable portion of each payment over their lifetime, based on the proportion of earnings to the annuityâ??s total value.

Example: How Early Withdrawals Are Taxed

John is 55 years old and owns an annuity worth $100,000 that he has not annuitized. He has paid a total of $75,000 in premiums since purchasing the contract, meaning his earnings total $25,000. John would like to withdraw $30,000 from his annuity. How will Johnâ??s withdrawal be taxed for federal income tax purposes?

Step by Step:

- John is 55 years old, which is younger than the 59 Â½ years old requirement. Therefore, withdrawals will be taxed on a LIFO basis and are subject to a 10 percent early-withdrawal

penalty on earnings.
- John wants to withdraw $30,000, and has $25,000 of earnings.
    - Because the withdrawal is taxed LIFO, earnings come out first.
    - The $25,000 is subject to the 10 percent early-withdrawal penalty, equivalent to $2,500, and taxable at Johnâ??s marginal tax rate as ordinary income.
    - The remaining $5,000 will come out tax-free as a return of basis.

However, if John decides to take payments through annuitization, 75 percent of Johnâ??s annuity ($75,000/$100,000) is basis, so 75 percent of withdrawals will be returned tax free.

Gifting Annuity Contracts

When the owner of an annuity gives their contract to another individual as a gift, special income tax rules apply. The donor, the person who originally owned the contract, is considered to have surrendered the contract. Income tax is due on the difference between the value of the contract, known as the *cash surrender value*, and the amount invested in the contract, or the basis. Additionally, standard gift tax rules apply.

Using our example from above, if John intends to gift his entire $100,000 non-annuitized annuity (cash surrender value) with a basis of $75,000 to his daughter, Mary, the following would apply:

- John gifts his $100,000 annuity to Mary.
- John pays ordinary income tax on $25,000. This is the $100,000 cash surrender value minus the $75,000 basis.
- Because the gift exceeds the annual gift tax exclusion amount, John is required to file a gift tax return using IRS Form 709. The amount exceeding the exclusion amount counts against Johnâ??s federal estate tax (FET) exemption.
- Mary, the recipient of the annuity, has no tax liability.

Aggregation of Annuities

The tax rules for owners of multiple annuities can be nuanced. If someone has multiple annuities meeting specific criteria, they cannot simply withdraw funds from one contract; rather, all contracts are combined, or aggregated, when calculating taxes, and the IRS treats multiple annuity contracts as a single annuity contract.

These criteria are that the annuity owner must:

1. Own multiple annuities
2. Have purchased these annuities after 1988
3. Have had the annuities issued by the same insurer

All three of these criteria must be satisfied for aggregation rules to apply. This is important, because annuities are taxed LIFO, which means earnings on the contract come out first and are subject to ordinary income tax rates.

Beneficiaries and Taxes

The tax treatment of an annuity after the ownerâ??s death depends on whether the contract has been *annuitized*.

After Annuitization

When the annuitant (annuity owner) dies while receiving benefits under a *term-certain annuity payment*, meaning the contract specifies a fixed period for payments even if the annuitant dies, the remaining payments of the contract are made to the annuitantâ??s beneficiary.

In this case, the beneficiary is subject to the same tax rules as the annuitant: The portion of the payment considered return of basis is tax free and the portion considered earnings is taxable at ordinary income tax rates.

Before Annuitization

When the annuitant dies before annuitization, which is commonly referred to as the accumulation phase, there are a range of options available that impact the tax treatment of the annuity, whether the annuityâ??s beneficiary is the annuitantâ??s estate or a named beneficiary that is not the annuitantâ??s estate.

Annuity Proceeds

If the annuity proceeds are retained by the estate of the owner, the estate will owe ordinary income tax on any gain in the contract, and the annuity value will be included in the gross estate of the owner. The estate will be entitled to a tax deduction on the decedentâ??s final income tax return for the additional estate tax attributable to the annuity value on the decedentâ??s estate tax return, if any.

If the annuity proceeds are paid to a named beneficiary, any tax on the gain is transferred to the beneficiary. The beneficiary is entitled to a tax deduction for the additional estate tax attributable to the annuity value on the decedentâ??s estate tax return, if any.

Annuities can serve as useful vehicles for financial planning; however, nuance and complexity associated with them warrant professional guidance. Please contact your CAPTRUST advisor to answer questions specific to your annuity.

Source:

Publication 575 (2024), Pension and Annuity Income | Internal Revenue Service

Resource by the CAPTRUST wealth planning team

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