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Annuities: Traps for the Unwary

Income from an annuity contract is divided into two categories: return of investment (also known as *basis*) and earnings. The basis is not taxed, but earnings are. Further, those 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 Distributions taken before age 59 1/2 incur a 10 percent early-withdrawal penalty tax if the withdrawn amount represents earnings rather than basis. Additionally, early withdrawals follow a *last-in, first-out* (LIFO) method, meaning all earnings must be exhausted before any basis can be returned tax free.

Example 1: How Early Withdrawals are Taxed

John is 55 years old and owns an annuity worth $100,000. He has paid a total of $75,000 in premiums since purchasing the contract, so his earnings total $25,000. John wants to withdraw $30,000 from his annuity. How will this withdrawal be taxed for federal income tax purposes?

- **Age matters.** John is 55, which is younger than the 59 1/2 threshold. Therefore, withdrawals are taxed on a LIFO basis and subject to a 10 percent early-withdrawal penalty on earnings.
- **Note the exact withdrawal amount.** John wants to withdraw $30,000, and his earnings total $25,000.
    - Under LIFO rules, earnings come out first.
    - The $25,000 of earnings is taxable at John’s ordinary income tax rate and subject to a 10 percent penalty of $2,500.
    - The remaining $5,000 is treated as a return of basis and is tax free.

Example 2: Withdrawal After Age 59 1/2

Now suppose John is 60 years old. The tax treatment changes significantly.

- **Age matters.** John is older than 59 1/2, so withdrawals are taxed proportionally and are not subject to the 10 percent early-withdrawal penalty.
- **Proportional taxation rules apply.** Seventy-five percent of John's annuity ($75,000 out of $100,000) is basis, so 75 percent of any withdrawal is tax free. John wants to withdraw $30,000.
    - Seventy-five percent of $30,0000—$22,500—will be returned tax free.
    - The remaining 25 percent of $30,000—$7,500—will be taxed at John's ordinary income tax rate.

What's the difference between making the same withdrawal at age 55 instead of age 60? An additional $17,500 in taxable ordinary income and a penalty of $2,500.

Gifting an Annuity: Tax Rules

When the owner of an annuity gives the contract to another individual as a gift, special income tax rules apply. The donor—the person who originally owned the contract—is treated as if they surrendered the contract. Income tax is due on the difference between the contract's cash-surrender value and the amount invested in the contract (the basis). Additionally, standard gift tax rules apply.

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

- 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 must file a gift tax return using IRS Form 709. The dollar amount over the exclusion threshold counts against John's federal estate tax (FET) exemption.
- Mary, as the recipient of the annuity, has no tax liability.

Aggregation of Annuities

The tax rules for owners of multiple annuities are more nuanced. If someone owns multiple annuities, they cannot simply withdraw funds from one contract without considering the others. For tax purposes, the IRS aggregates all annuity contracts and treats them as a single contract.

For this example, assume that John's $100,000 annuity is actually four separate $25,000 annuities. John is 60 years old, so there is no early-withdrawal penalty in this scenario.

- **Annuity 1**: Value =$25,000, basis = $25,000
- **Annuity 2**: Value =$25,000, basis = $20,000
- **Annuity 3**: Value =$25,000, basis = $15,000
- **Annuity 4**: Value =$25,000, basis = $15,000

It might seem intuitive that John could withdraw the entire $25,000 from Annuity 1 tax free, since its value equals its basis. However, because all four contracts are aggregated, the IRS treats them as one contract with a combined value of $100,000 and a combined basis of $75,000.

Withdrawing $25,000 on a LIFO basis means withdrawing the full $25,000 of earnings first, making the entire withdrawal taxable at ordinary income tax rates.

Beneficiaries and Taxes

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

If the annuitant (the annuity owner) dies while receiving benefits under a *term-certain annuity*, meaning that the contract specifies a fixed period for payments even if the annuitant dies, then the remaining payments of the contract are made to the annuitant's beneficiary. In this case, the beneficiary is subject to the same tax rules as the annuitant.

- The portion of each payment considered a return of basis is tax free.
- The portion considered earnings is taxable at ordinary income tax rates.

If the annuitant dies before the contract is annuitized, at time that is commonly referred to as the accumulation phase, any gain on the contract is recognized and taxes are due on that amount.

Treatment of Annuity Proceeds

If the annuity proceeds are retained by the estate of the owner, the estate owes ordinary income tax on any gain in the contract, and the annuity's value is included in the owner's gross estate. The estate is entitled to an income tax deduction on the decedent's final return for the additional estate tax attributable to the annuity value reported on the estate tax return, if any.

If the annuity proceeds are paid to a named beneficiary, any tax on the gain transfers to the beneficiary. The beneficiary is entitled to an income tax deduction for any additional estate tax attributable to the annuity value reported on the decedent's estate tax return, if any.

Annuities can be valuable tools for financial planning, but their complexity often warrants professional guidance. Contact your CAPTRUST financial advisor for answers to questions specific to your annuity.

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Resource by the CAPTRUST wealth planning team

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