TAXATION OF NONQUALIFIED ANNUITIES

Question: How are nonqualified annuities taxed?

Bottom line: There are two ways to take funds from a nonqualified deferred annuity: through withdrawals or annuitization. (By definition, the only way to take funds from a nonqualified immediate annuity is through annuitization). For withdrawals, any contract interest or gain that has exceeded the owner's investment in the contract (also commonly known as cost basis) is distributed first, followed by basis (basis consists of the client's after-tax contributions to the nonqualified deferred annuity). Interest is taxed as ordinary income, while return of basis is income-tax-free. If your client elects to annuitize their contract, each annuitization payment is considered part taxable interest and part income-tax-free return of basis. Exceptions to this general rule may apply if any funds are from contracts issued prior to August 14, 1982.

What is a nonqualified annuity? A nonqualified annuity is an annuity that is not inside an IRA or qualified retirement plan. Qualified plan and IRA contributions are based on the income an employee earns at a job, and contributions are limited. In contrast, anyone can buy a nonqualified annuity in almost any amount, regardless of whether or not they have a job. People buy nonqualified annuities with funds from various assets, but NOT from IRAs or qualified plans.

Can my client deduct their premium payments to a nonqualified annuity? No. Unlike traditional IRA contributions, they cannot deduct their payments for a nonqualified annuity.

Do they have to pay tax on the increase in value in their nonqualified deferred annuity each year? No. Unlike many other assets, there is no annual income tax on the interest earnings inside of a nonqualified deferred annuity for individual owners. Generally, increase in value is only taxed when they remove it in a distribution or complete a transaction that results in a taxable event.

Example: Vaughn puts $100,000 into a nonqualified deferred annuity in February. By December 31, it had increased $5,000 in value. Vaughn will not receive an IRS Form 1099-R on the $5,000 during the year. He will only be taxed on the interest when he withdraws the funds, which will likely be during retirement.

Tax deferral is one of the chief advantages of nonqualified deferred annuities over other nonqualified assets. However, in exchange for tax deferral, Uncle Sam wants them to keep the funds in the annuity until retirement. There will be a 10% federal additional tax if they remove the funds before age 59½ (discussed below) and no exception applies.

Note that non-natural owners such as corporations, LLCs, and charities are not eligible for income tax deferral of increases in value of a nonqualified deferred annuity. They must pay tax on the interest each year, or for charitable owners, report the interest on the informational return they file each year.

How are distributions from a nonqualified annuity taxed? The Internal Revenue Code recognizes two ways to take funds from a nonqualified deferred annuity: through withdrawals or annuitization. These are taxed differently.

A regular withdrawal or distribution is taxed as interest out first, followed by basis (basis is total of the premiums paid for the annuity, including premiums paid before any 1035 exchange). Interest is taxed as ordinary income, but the return of basis is income-tax-free. Exceptions to this general rule may apply if any premium payments were made prior to August 14, 1982.

Example: After eight years, Vaughn's $100,000 nonqualified deferred annuity is now worth $150,000. Vaughn withdraws $60,000. The first $50,000 of the distribution represents the interest earned on the contract, which is subject to ordinary income tax and may be subject to the 10% federal additional tax if he is under age 59½. The other $10,000 of the withdrawal is income-tax-free return of basis. Vaughn will receive an IRS Form 1099-R for $60,000, with $50,000 reported as taxable. Immediately after the distribution, Vaughn will have $90,000 in basis and no interest earnings in the contract. This example does not take into consideration any possible surrender charges on the annuity.

Old contracts entered into before August 14, 1982 have a different ordering rule for withdrawals. It may be possible to withdraw basis before interest earnings on pre-August 14, 1982 money.

ORDER OF DISTRIBUTION:

- Pre-August 14, 1982 contributions (nontaxable)
- Interest on pre-August 14, 1982 contributions (taxable)
- Interest on post-August 13, 1982 contributions (taxable)
- Post-August 13, 1982 contributions (nontaxable)

What if the contract was initially issued before August 14, 1982 but it has been "1035 exchanged" since then? That older contract retains the pre-August 14, 1982 tax benefits and the client will want to make sure that the prior carrier supplies Allianz or Allianz Life of NY with the appropriate basis and interest information. Without complete prior cost basis and interest information from the other company, Allianz or Allianz Life of NY will treat the contract as having no cost basis for withholding purposes and will report distributions as "taxable amount not determined."

The other way to remove funds from a nonqualified deferred annuity is to annuitize the contract. When a contract is annuitized, the cash value of the annuity is changed into a stream of income that lasts for life or a guaranteed period. This stream of income is a systematic liquidation of the basis and expected interest on the contract. There generally is no cash value left in the contract after it is annuitized.

Each annuitization payment is considered part taxable interest and part income-tax-free return of basis. If the payment is a fixed amount, each payment has an "exclusion ratio" of basis to interest. If the payment amount can vary, each payment has an "excludable amount" that will be considered basis. Again, the basis portion is not taxed, and the interest portion is taxed as ordinary income.

Example: Let's say after eight years Vaughn annuitizes his $150,000 contract over a 10-year guaranteed period. The insurance company promises an annual payment of $18,200 annually for 10 years. Each payment consists of $10,000 income-tax-free basis (that is, the $100,000 basis liquidated over 10 years) and $8,200 interest (from the $50,000 gain at the beginning of the annuitization and the promised return during the upcoming 10 years of the annuitization). This gives an exclusion ratio of about 55%. That is, 55% of each $18,200 payment is income-tax-free return of basis. If Vaughn takes an annuitization for life instead of a guaranteed period, the basis is liquidated over his life expectancy. If he lives longer than that and has therefore collected back all of his basis, all payments after that will be taxable interest. The actual exclusion ratio calculation is based on IRS guidelines and can be complex for certain annuitization options.

Again, all interest on annuities is ordinary income. They do not generate any capital gain income.

How are payments from lifetime income withdrawal options treated? Since lifetime income withdrawal options are a way of guaranteeing lifetime income without annuitizing, these payments are taxed as distributions. If the contract value is depleted prior to death, all future payments will be treated as annuitization payments and will be fully taxable.

What happens if I take a distribution before age 59½? As stated earlier, Uncle Sam gives you tax-deferred accumulation on nonqualified deferred annuities provided that you are saving for retirement. There is a 10% federal additional tax to "disincent" you from withdrawing early. If a nonqualified deferred annuity owner takes a distribution before age 59½, Code Section 72(q) will impose a 10% federal additional tax for a "premature distribution" unless an exception applies. The 10% federal additional tax is only applied against the taxable part of the distribution, that is, the interest earnings (increase in value).

(continued on next page)

Example: Suppose Vaughn took his $60,000 distribution (described earlier) when he was only 55 years old and no exception applies. In addition to paying income tax on the $50,000 interest, he will also pay a 10% federal additional tax ($5,000). He does not have to pay the additional tax on the $10,000 of basis he took out, because that amount is not taxable.

Congress saw that this additional tax could be onerous, so it carved out several exceptions. There is no 10% federal additional tax if the owner dies or becomes disabled.

There is no 10% federal additional tax if you receive annuity payments from a nonqualified **immediate** annuity (assuming the purchase is not part of a 1035 exchange). Note that it is generally not possible to 1035 exchange an immediate or an annuitized annuity. There is also no additional tax if the owner withdraws through a series of "substantially equal periodic payments" over their life expectancy. This latter exception allows someone who retires early to take distributions from their nonqualified deferred annuity without additional tax. See the "SEPP exception to 72(t) and 72(q)" Q&A.

Aggregation of gain within multiple contracts

Code Section 72(e)(12) provides that multiple nonqualified deferred annuity contracts issued within the same calendar year to the same owner by one company or its affiliates are treated as one annuity contract for purposes of determining a distribution's tax consequences. If a distribution is taken from any such contract, the taxable amount reported will be based on earnings of all such contracts. This treatment may result in adverse tax consequences, including more rapid taxation of distribution from combined contracts. For purposes of this rule, contracts received in a Section 1035 exchange are considered issued in the year of the exchange. Your client should consult a tax advisor before purchasing more than one nonqualified deferred annuity contract in any calendar year period. Note: A contract that would otherwise be aggregated is not aggregated if it is annuitized or is involved in a 1035 exchange to another company.

Does your client have to recognize interest on their contract if they exchange it for another one? No. They don't have to pay income tax on their interest earnings when they exchange their annuity contract for another, provided they follow certain rules. To be a nontaxable 1035 exchange the exchange must be made in a company-to-company transfer, and the parties to the contract must not change from the old contract to the new contract in the course of the exchange. See the 1035 exchanges Q&A.

Example: Vaughn's contract has $100,000 in basis and $50,000 in interest (increase in value). Vaughn is owner and annuitant on his nonqualified deferred annuity. Vaughn is unhappy with his current contract, and has found a competitor's contract that he likes better. Vaughn can exchange his $150,000 contract by arranging a company-to-company transfer into the new $150,000 nonqualified deferred annuity. The new annuity names Vaughn as owner and annuitant. This is therefore a valid 1035 exchange. Vaughn does not have to recognize his $50,000 interest earnings in the first contract. His new annuity carries over the $100,000 basis and the $50,000 interest earnings (increase in value) from the old contract. Even though Vaughn paid $150,000 for the new annuity, he still has a $100,000 basis because it carried over from the old contract in an exchange. This does not take into account any possible surrender charges. To be sure both companies treat the transaction as a 1035 exchange, it is recommended that the individual not receive anything at their own address.

Are there income tax consequences if a client gifts their nonqualified annuity to someone else? Yes. The original owner (or transferor) will pay tax on any interest earnings, unless an exception applies. The new owner will take the annuity with a new, stepped-up basis.

Example: Vaughn has his $150,000 annuity, $50,000 of which is interest. Vaughn gives the annuity to his daughter Sophie. Vaughn pays income tax on the $50,000 interest earnings, and Sophie takes a new $150,000 basis in her contract.

There is an exception if your client gifts their annuity to their spouse. There is no tax on gifting their annuity to their spouse. The spouse keeps the same basis.

Can my client borrow against their nonqualified deferred annuity or put it up for collateral? It depends upon the business rules of the annuity provider. However, if they are allowed to borrow against the contract or use it as collateral, it will be treated like a distribution from the contract. They will be ordinary income-taxed (and perhaps subject to the 10% federal additional tax) to the extent of interest earnings in the "distribution."

Do they have to take required minimum distributions (RMDs) from a nonqualified deferred annuity? No. Unlike qualified annuities, there are no RMDs required from nonqualified deferred annuities. Nonqualified deferred annuities do have a maximum annuity date, though, at which point the owner must take a lump sum or annuitize.

How is their nonqualified deferred annuity taxed after they die? Nonqualified deferred annuities do not receive a basis step-up at death, because they are not capital gain assets. Instead, they have income in respect of a decedent (IRD). That is, the beneficiary steps into the shoes of the decedent for tax purposes, taking over the decedent's basis and interest. When a beneficiary takes a distribution or annuitizes, it is taxed in the same manner previously described.

Example: Vaughn never took a distribution from his nonqualified deferred annuity during life. He died with $100,000 of basis, and $120,000 of interest earnings. After his death, the contract gains an additional $5,000 before his daughter Sophie takes a lump sum of the entire amount. She pays income tax at her ordinary rates (not Vaughn's) on the $125,000 of interest, and receives income-tax-free the $100,000 return of basis. If Vaughn paid estate tax on the annuity, Sophie may be eligible for an income tax deduction for the estate taxes that Vaughn paid. This is called the IRD deduction. We have more detail on IRD and the deduction in the "IRD and the 691(c) deduction" Q&A listed elsewhere in this booklet.

What options does a beneficiary have after the owner dies (and the nonqualified deferred annuity contract has not been annuitized)? If the beneficiary is the spouse, they can continue the contract in their own name and assume the deceased owner's tax basis and interest. Or, they could take one of the options available to nonspouse beneficiaries when death occurs before annuity payments have begun: distribution of the entire contract within five years of the owner's death, or distributions over the beneficiary's life expectancy or a guaranteed period not exceeding the life expectancy. (This option may not be available in all states and for all contracts. If the beneficiary elects life expectancy distribution, the first distribution must be taken by the first anniversary of the owner's date of death.) If the beneficiary does not receive the first distribution by then, the entire value must be distributed within five years of the owner's death. The beneficiary can also take a lump sum.

If the owner had annuitized the contract before death under an annuity option other than "life-only," the beneficiary can take any remaining payments or commute the contract, if the provider and contract provisions allow.

Where can I find out more about some of the topics discussed? This booklet has more detailed Q&As on the following topics:

- 1035 exchanges (page 57)
- 72(t) and 72(q) distribution basics (page 49)
- IRD and the 691(c) deduction (page 61)