The 10 Key Facts to Understand Annuities

(Expanded version)

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1. There are four broad ways to classify an annuity.

Understanding that any one annuity contract may be described accurately by several different labels is essential to an understanding of how it works. It is possible to divide all annuity contracts into different types using four different parameters:

1. How is the annuity purchased? (Single premium vs. Flexible premium)
2. When do regular annuity payments commence? (Immediate vs. Deferred)
3. How are contract values and premiums invested? (Fixed vs. Variable)
4. How is the contract taxed? (Qualified vs. Nonqualified)

2. There are four parties to an annuity contract.

1. The insurance company is the party that issues the policy, and is obligated to keep all the promises made in it. (Only insurance companies can issue annuity contracts).
2. The annuitant is the individual—and it must be an individual, a human being—who may or may not also be the owner of the policy. The age and sex of the annuitant determine—for life annuities—the amount of each annuity payment. The annuitant is merely the measuring life for purposes of annuity payment calculations.
3. The beneficiary is the party who will receive any death benefit payable under the annuity, whether as a lump sum or by a continuation of annuity payments upon the death of the primary annuitant. However, not all annuities will have a beneficiary because if payments cease at the annuitant's death, there is nothing for a beneficiary to receive. In most cases the beneficiary has no other rights, unless the beneficiary is named irrevocably.
4. The owner is the individual or entity—it need not be a natural person—that has all ownership rights in the contract, including the right to name the annuitant and beneficiary, to elect commencement of annuity payments, and to surrender the contract.

3. There are Deferred Annuities, and then there are Longevity Annuities.

A deferred annuity provides for an initial waiting period before the contract can be annuitized (usually between one and five years), and during that period the contract's cash value generally remains liquid and available (albeit potentially subject to surrender charges). Beyond the initial waiting period the contract may be annuitized, though the choice remains in the hands of the annuity policyowner, at least until the contract's maximum maturity age (at which point it must be annuitized).

By contrast, a longevity annuity generally provides no access to the funds during the deferral period, and does not allow the contract to be annuitized until the owner reaches a certain age (usually around eighty-five).

In other words, many taxpayers purchase traditional deferred annuity products with a view toward waiting until old age to begin annuity payouts, but they always have the option of beginning payouts at an earlier date. With a longevity annuity, there is generally no choice, but this also allows for larger payments for those who do survive to the starting period; as a result, for those who survive, longevity annuities typically provide for a larger payout (often, much larger) than traditional deferred annuity products.

4. Annuities don't just pay out during the owner's lifetime.

Death benefit, withdrawal, and commutation options have, in recent years, become more varied and more numerous, in much the same way that "guaranteed living benefit" riders on variable annuities proliferated a few years ago. Consumers are becoming more aware of the existence of deferred income annuities, especially since the issuance of QLAC regulations and financial advisors are increasingly more willing to consider incorporating these instruments into their clients' financial plans. More insurance companies are offering deferred income annuities and sales have increased dramatically, though they are still a very small part of the overall annuity market.

5. Annuities can be purchased with tax-deferred retirement savings.

A qualified longevity annuity contract (QLAC) is a type of longevity annuity ("deferred income annuity") that meets certain IRS requirements that have been developed in order to encourage the purchase of annuity products with retirement account assets. A QLAC is a type of deferred annuity product that is usually purchased before retirement, but for which payouts are delayed until the taxpayer reaches old age.

6. 401(k) plan sponsors can include deferred annuities in TDFs.

IRS Notice 2014-66 specifically permits 401(k) plan sponsors to include deferred annuities within TDFs without violating the nondiscrimination rules that otherwise apply to investment options offered within a 401(k). This is the case even if the TDF investment is a qualified default investment alternative (QDIA)—which is a 401(k) investment that is selected automatically for a plan participant who fails to make his or her own investment allocations.

7. A grantor trust can own a deferred annuity contract.

A grantor trust can own a deferred annuity contract, but, in certain circumstances, the "non-natural person rule" of IRC Section 72(u) will cause the denial of the tax-deferral benefits to a deferred annuity owned by a trust. If annuity tax benefits are denied under the non-natural person rule, income on the annuity for any taxable year will be treated as ordinary income received. However, if a trust owns a deferred annuity contract as the agent for a natural person, Section 72(u) does not apply.

8. Taxation of annuity payments is split.

The basic rule for taxing annuity payments is designed to return the purchaser's investment in equal tax-free amounts over the payment period (e.g., the annuitant's life expectancy or a guaranteed certain period of time) and to tax the balance of each payment received as earnings. Each payment is part nontaxable return of cost and part taxable income. Any excess interest (dividends) added to the guaranteed payments is reportable as income for the year received.

9. Annuity contracts can be partially annuitized.

When a contract is partially annuitized: (1) each annuitized portion of the contract is treated as a separate contract; (2) for purposes of calculating the taxable portion of annuity payments from a partially annuitized contract, investment in the contract is allocated pro rata between each portion of the contract from which amounts are received as an annuity and the portion of the contract from which amounts are not received as an annuity; and (3) each separately annuitized portion of the contract will have a separate annuity start date.

10. Annuities can be part of a Section 1035 Exchange.

Section 1035 of the tax code allows for the exchange of an annuity for another annuity contract in a like-kind exchange without recognition of gain. These rules allow an annuity holder to exchange one annuity contract for another, perhaps to obtain different or more appealing investment options or guarantees, while deferring any income tax liability associated with a gain.

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