

# LIFE & DEATH TAXATION OF DEFERRED ANNUITIES

6.10.2019 | AICPA ENGAGE

## MICHAEL E. KITCES

MSFS, MTAX, CFP®, CLU, ChFC, RHU, REBC, CASL

Partner, Director of Research, Pinnacle Advisory Group

Publisher, The Kitces Report, [www.kitces.com](http://www.kitces.com)

Blogger, Nerd's Eye View, [www.kitces.com/blog](http://www.kitces.com/blog)

Twitterer, @MichaelKitces, [www.twitter.com/MichaelKitces](http://www.twitter.com/MichaelKitces)



Handouts/Additional Materials at: [kitces.com/AICPAEN19](http://kitces.com/AICPAEN19)

1

## TAXATION OF DEFERRED ANNUITIES

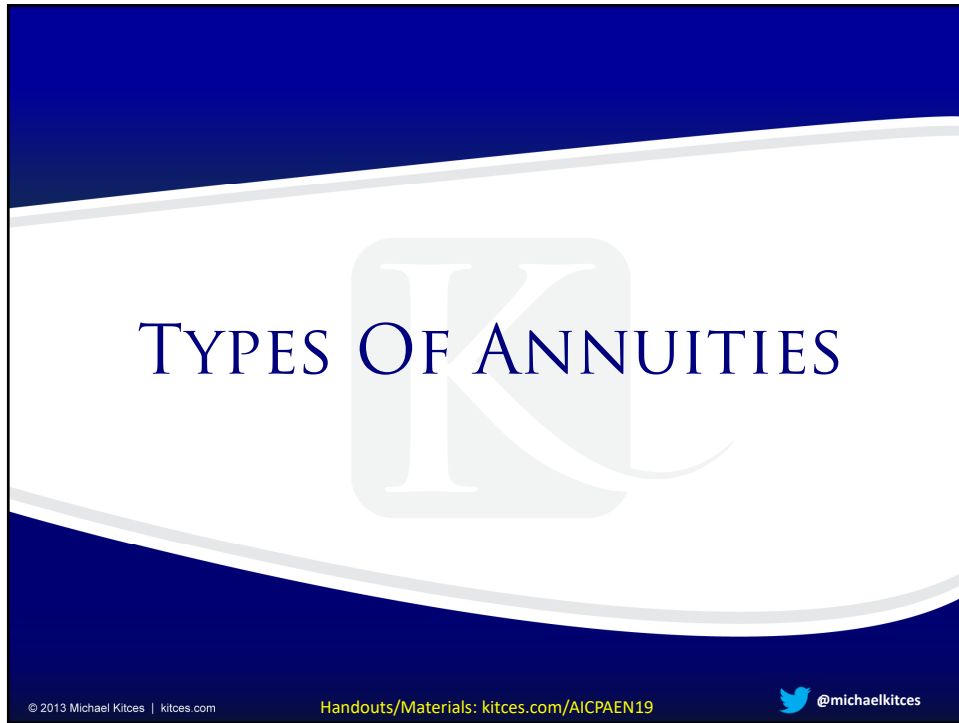
- Outline
  - Types of annuities
  - Tax treatment of annuities during life
  - Tax treatment of annuities at death
  - Required distributions of annuities at death
  - Unique complications of annuities at death

© 2013 Michael Kitces | [kitces.com](http://kitces.com)

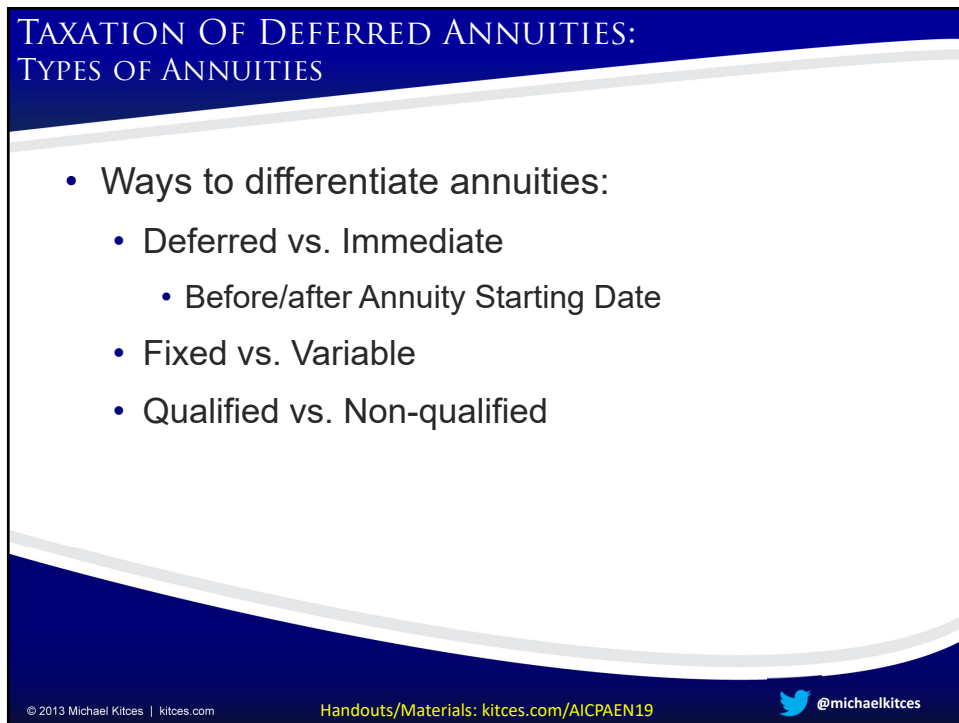
Handouts/Materials: [kitces.com/AICPAEN19](http://kitces.com/AICPAEN19)

 @michaelkitces

2



3



4

## TAXATION OF DEFERRED ANNUITIES: TYPES OF ANNUITIES

- Deferred annuities
  - Types of deferred annuities
    - Fixed Annuity (FA)
      - Produces “CD-like” returns
    - Variable Annuity (VA)
      - Invest amongst available sub-accounts
    - Equity-Indexed Annuity (EIA)
      - Hybrid structure

© 2013 Michael Kitces | [kitces.com](http://kitces.com)

Handouts/Materials: [kitces.com/AICPAEN19](http://kitces.com/AICPAEN19)

 @michaelkitces

5

## TAXATION OF DEFERRED ANNUITIES: TYPES OF ANNUITIES

- Parties to the contract
  - Owner
    - Owns the contract and has a right to make decisions about the contract
  - Annuitant
    - Measuring life of the contract
  - Insurance company
  - Beneficiary

© 2013 Michael Kitces | [kitces.com](http://kitces.com)

Handouts/Materials: [kitces.com/AICPAEN19](http://kitces.com/AICPAEN19)

 @michaelkitces

6

# TAX TREATMENT DURING LIFE

© 2013 Michael Kitces | [kitces.com](http://kitces.com)

Handouts/Materials: [kitces.com/AICPAEN19](http://kitces.com/AICPAEN19)

 @michaelkitces

7

## TAXATION OF DEFERRED ANNUITIES: TAX TREATMENT DURING LIFE

- Tax-deferral
  - Only applies if owned by a natural person
  - Exception where ownership is “as an agent for a natural person”
    - Trusts as agent
    - Partnerships
    - Other entities
  - Grandfathering exception for pre-March 1, 1986 contracts
  - IRA annuities are subject to IRA rules

© 2013 Michael Kitces | [kitces.com](http://kitces.com)

Handouts/Materials: [kitces.com/AICPAEN19](http://kitces.com/AICPAEN19)

 @michaelkitces

8

## TAXATION OF DEFERRED ANNUITIES: TAX TREATMENT DURING LIFE

- Distributions from annuities
  - Amounts “not received as an annuity”
  - Withdrawals from post-August 13, 1982 contracts
    - Income first to the extent of gains (LIFO)
  - Withdrawals from pre-August 14, 1982 contracts
    - Principal first to the extent of pre-1982 payments (FIFO)
  - Aggregation anti-abuse rules
  - Loans, pledges, or assignments treated as immediately taxable

© 2013 Michael Kitces | [kitces.com](http://kitces.com)

Handouts/Materials: [kitces.com/AICPAEN19](http://kitces.com/AICPAEN19)

 @michaelkitces

9

## TAXATION OF DEFERRED ANNUITIES: TAX TREATMENT DURING LIFE

- Distributions from annuities
  - Premature withdrawal penalties
    - 10% penalty, but applies *only* to the amount of gain reported in income
    - Exceptions to the penalty include:
      - After age 59 ½
      - Death
      - Disability
      - Substantially equal periodic payments
      - Immediately annuity where payments begin within 1 year of purchase

© 2013 Michael Kitces | [kitces.com](http://kitces.com)

Handouts/Materials: [kitces.com/AICPAEN19](http://kitces.com/AICPAEN19)

 @michaelkitces

10

## TAXATION OF DEFERRED ANNUITIES: TAX TREATMENT DURING LIFE

- Distributions from annuities
  - Taxation of partial withdrawals determined *without* regard to surrender charges
    - \$100,000 cost basis, \$105,000 cash value, \$10,000 surrender charge
      - Partial withdrawal: \$5,000 of ordinary income and subsequent loss recapture
  - Full surrender exception
    - Taxable only to the extent net proceeds exceed cost basis
    - \$100,000 cost basis, \$105,000 cash value, \$10,000 surrender charge
      - Full surrender: \$5,000 loss

© 2013 Michael Kitces | kitces.com

Handouts/Materials: [kitces.com/AICPAEN19](http://kitces.com/AICPAEN19)

 @michaelkitces

11

## TAXATION OF DEFERRED ANNUITIES: TAX TREATMENT DURING LIFE

- Complete surrenders of annuities
  - Gain reported to the extent of gain
- Deductions for deferred annuity losses
  - Allowed as an ordinary loss
  - **Was** claimed as a miscellaneous itemized deduction subject to the 2% floor
    - **Itemized deduction no longer allowed**
    - Above-the-line ordinary loss claims controversial

© 2013 Michael Kitces | kitces.com

Handouts/Materials: [kitces.com/AICPAEN19](http://kitces.com/AICPAEN19)

 @michaelkitces

12

# TAX TREATMENT AT DEATH

© 2013 Michael Kitces | kitces.com

Handouts/Materials: [kitces.com/AICPAEN19](http://kitces.com/AICPAEN19)

 @michaelkitces

13

## TAXATION OF DEFERRED ANNUITIES: TAX TREATMENT AT DEATH

- Contract remains in current form
  - Estate tax valuation based on cash surrender value
    - May include adjustments due to death itself
  - Post-death distributions continue to be treated as amounts not received as an annuity, unless annuitized by beneficiary
  - Rules requiring distributions from annuity after death

© 2013 Michael Kitces | kitces.com

Handouts/Materials: [kitces.com/AICPAEN19](http://kitces.com/AICPAEN19)

 @michaelkitces

14

## TAXATION OF DEFERRED ANNUITIES: TAX TREATMENT AT DEATH

- Post-death distribution requirements
  - Annuity is *required* to begin making distributions upon the death of *any owner*
    - May force distributions while annuitant or remaining owner is alive if (different) owner has died
    - If annuity is owned by a non-natural person, primary annuitant is substituted for owner
  - Time period for required distributions will depend upon beneficiaries and annuity contract

© 2013 Michael Kitces | kitces.com

Handouts/Materials: [kitces.com/AICPAEN19](http://kitces.com/AICPAEN19)

 @michaelkitces

15

## TAXATION OF DEFERRED ANNUITIES: TAX TREATMENT AT DEATH

- Post-death distribution requirements
  - Default – the 5-year rule
    - Entire contract must be distributed by the 5<sup>th</sup> *anniversary date* of the owner's date of death
      - Different than retirement account rules!
  - Exceptions to the 5-year rule
    - Distributions may be made over the life expectancy of a *designated beneficiary*
    - Spousal continuation

© 2013 Michael Kitces | kitces.com

Handouts/Materials: [kitces.com/AICPAEN19](http://kitces.com/AICPAEN19)

 @michaelkitces

16



## TAXATION OF DEFERRED ANNUITIES: TAX TREATMENT AT DEATH

- Post-death distribution requirements
  - Payments over life expectancy
    - *Must* begin within 1 year of the owner's death
  - Requires a designated beneficiary
    - "Any *individual* designated as a beneficiary by the owner of the annuity contract"

© 2013 Michael Kitces | kitces.com

Handouts/Materials: [kitces.com/AICPAEN19](http://kitces.com/AICPAEN19)

 @michaelkitces

17

## TAXATION OF DEFERRED ANNUITIES: TAX TREATMENT AT DEATH

- Post-death distribution requirements (con't)
  - Annuitization to satisfy life expectancy payments
  - Systematic withdrawals to satisfy life expectancy payments
    - Not allowed by all companies (based on PLR)
    - Payments must begin within 12 months of the decedent's date of death (non-calendar year; tax shifting possible)
    - Tax treatment allows cost basis to be allocated over the distribution period as an amount received as an annuity

© 2013 Michael Kitces | kitces.com

Handouts/Materials: [kitces.com/AICPAEN19](http://kitces.com/AICPAEN19)

 @michaelkitces

18

## TAXATION OF DEFERRED ANNUITIES: TAX TREATMENT AT DEATH

- Post-death distribution requirements (con't)
  - Spousal continuation
    - Surviving spouse must be the beneficiary
    - Allows for the spouse to continue the contract in his/her own name
    - Contract continues 'normal' deferred annuity treatment in the name of the spouse
      - Upon death of spouse, normal rules apply based upon the death of the owner
      - Impact on living or death benefits of annuity will depend on the terms of the contract

© 2013 Michael Kitces | [kitces.com](http://kitces.com)

Handouts/Materials: [kitces.com/AICPAEN19](http://kitces.com/AICPAEN19)

 @michaelkitces

19

## TAX TREATMENT AT DEATH: *OTHER NOTABLE ISSUES*

© 2013 Michael Kitces | [kitces.com](http://kitces.com)

Handouts/Materials: [kitces.com/AICPAEN19](http://kitces.com/AICPAEN19)

 @michaelkitces

20

## TAXATION OF DEFERRED ANNUITIES: OTHER ISSUES AT DEATH

- Other notable items
  - Income in Respect of a Decedent
    - Annuities are treated as IRD amounts
    - Post-death distributions may provide for an IRD income tax deduction
    - Be cautious of post-death assignments of benefits that trigger IRD recognition
      - Assignments from estate to estate beneficiary or trust to trust beneficiary
      - Must have ability to make non-pro rata and in-kind distributions
      - Be cautious of satisfying pecuniary bequests; cross-application of IRA-based rulings

© 2013 Michael Kitces | [kitces.com](http://kitces.com)

Handouts/Materials: [kitces.com/AICPAEN19](http://kitces.com/AICPAEN19)

 @michaelkitces

21

## TAXATION OF DEFERRED ANNUITIES: OTHER ISSUES AT DEATH

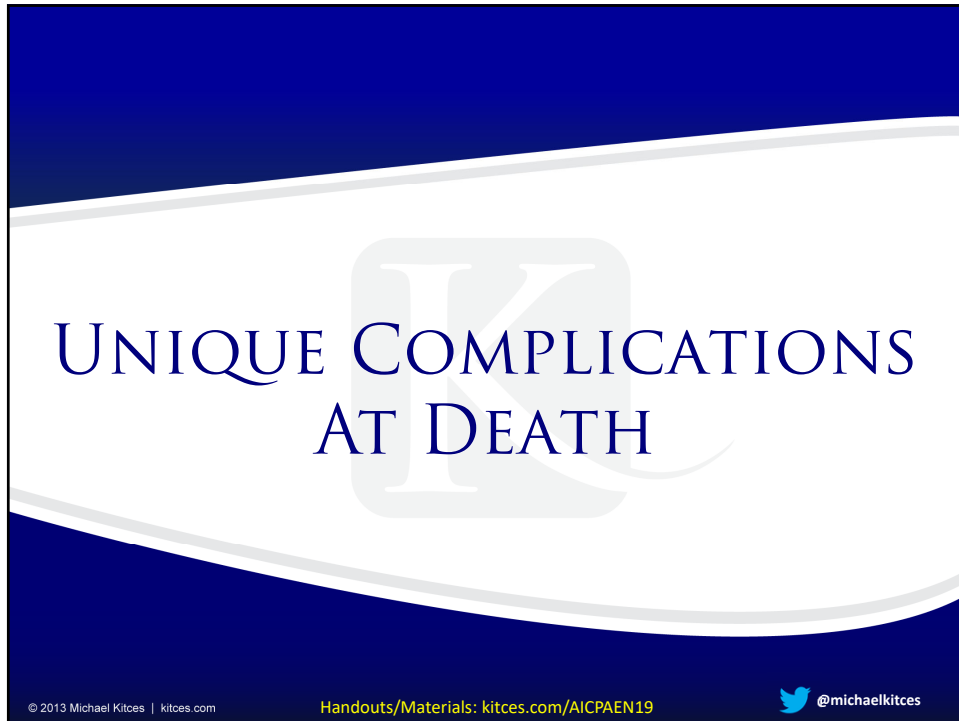
- Other notable items
  - Step-up in basis
    - Applicable only to pre-October 21, 1979 contracts
      - Variable vs. Fixed
      - Beware of exchanging eligible contracts!
  - Post-death 1035 exchanges
    - Appears to be blessed under PLR 201330016
    - Still depends on contract-specific language

© 2013 Michael Kitces | [kitces.com](http://kitces.com)

Handouts/Materials: [kitces.com/AICPAEN19](http://kitces.com/AICPAEN19)

 @michaelkitces

22



23

TAXATION OF DEFERRED ANNUITIES:  
UNIQUE COMPLICATIONS AT DEATH

- Trusts as beneficiaries
  - Designated beneficiary status is restricted to “individuals”
    - Trusts are not designated beneficiaries, and must follow the 5-year rule
    - Lack of “look-through” regulations; no on-point guidance
    - Parity with IRC Section 401(a)(9) (and the lack thereof)
  - Spousal continuation
    - PLR guidance for continuation with a Revocable Living Trust (RLT)
    - Potential to make post-death assignment through RLT

© 2013 Michael Kitces | [kitces.com](http://kitces.com) Handouts/Materials: [kitces.com/AICPAEN19](http://kitces.com/AICPAEN19) @michaelkitces

24

## TAXATION OF DEFERRED ANNUITIES: UNIQUE COMPLICATIONS AT DEATH

- Jointly held annuities
  - Payouts to third-party beneficiaries
    - Annuity contract may follow beneficiary designation to the exclusion of surviving owner
    - Inter-vivos gift from surviving owner to beneficiary
    - Potential loss of spousal continuation
    - Annuity contract provisions may “save” by contractually overriding beneficiary designation
  - Non-spousal joint owners
    - No opportunity for contract continuation at 1<sup>st</sup> death
    - Beware payouts to third-party beneficiaries

© 2013 Michael Kitces | [kitces.com](http://kitces.com)

Handouts/Materials: [kitces.com/AICPAEN19](http://kitces.com/AICPAEN19)

 @michaelkitces

25

## TAXATION OF DEFERRED ANNUITIES: UNIQUE COMPLICATIONS AT DEATH

- Multiple beneficiaries
  - Lack of clarity on how to handle multiple beneficiaries
    - No designated beneficiary determination date
    - Whose life expectancy is used; can contract be split?
    - Consequences of designated and non-designated beneficiaries?

© 2013 Michael Kitces | [kitces.com](http://kitces.com)

Handouts/Materials: [kitces.com/AICPAEN19](http://kitces.com/AICPAEN19)

 @michaelkitces

26

## TAXATION OF DEFERRED ANNUITIES: SUMMARY

- Summary
  - Annuities have a unique tax structure of their own
  - Be aware of both tax treatment and potential for grandfathered tax rules
  - Be certain to have all of the information before you act
  - Consider addressing problem situations before death, if possible (e.g., trusts as beneficiaries, ownership structuring issues, etc.)

© 2013 Michael Kitces | [kitces.com](http://kitces.com)

Handouts/Materials: [kitces.com/AICPAEN19](http://kitces.com/AICPAEN19)

 @michaelkitces

27

## QUESTIONS?

**Handouts & additional materials:**  
**[www.kitces.com/AICPAEN19](http://www.kitces.com/AICPAEN19)**

Contact: [questions@kitces.com](mailto:questions@kitces.com)

© 2013 Michael Kitces | [kitces.com](http://kitces.com)

 @michaelkitces

28