#10: Nonqualified Tax Deferred Annuities

Deferred annuities are another income smoothing strategy. Basically, a taxpayer, during higher tax bracket years, will invest in deferred annuities, thereby reducing taxable income, and thus, income taxes and the net investment income tax (NIIT). Then later, when the taxpayer is in lower tax bracket years, payments from the deferred annuities will begin, thus, smoothing out income and subjecting the taxpayer to lower taxes.

Deferred annuities are often purchased to provide for or to supplement retirement savings. While annuities are not qualified retirement plans, they do still receive preferential tax treatment – the earnings accumulate tax-free and are not taxable until withdrawn. Deferred annuities may be either fixed or variable; fixed annuities pay a fixed interest rate while variable annuities allow the annuity owner to select from various investment options that produce variable rates of return, e.g., stock and bond mutual funds.

Taxation of Fixed Annuities

Different tax rules apply depending on whether a distribution from an annuity is an annuity payment or a non-annuity payment. Annuity payments are payments that are:

1. Received on or after an annuity starting date;
2. Payable in regular periodic intervals (e.g., monthly, quarterly, semi-annually); and
3. Either the total is determinable at the starting date (i.e., fixed annuity) or the payments are made over a definite or determinable time, such as a term of years or life expectancy (i.e., variable annuity).[26]

Payments that meet these requirements are taxed by applying an exclusion ratio, which divides the amount received as an annuity into a taxable portion and a tax-free recovery of basis. In the case of a fixed annuity, the exclusion ratio is the investment in the contract divided by the expected return on the contract.[27] The investment in the contract is generally the total amount of premiums paid.[28] The expected return on the contract is the total amount to be received under the contract as of the annuity starting date.[29] In the case of a term annuity, it is the amount of each payment times the number of payments to be received.[30] In the case of a life annuity, it is the amount of the payments times the number of payments expected to be received based on the annuitant's life expectancy from Table V of Reg. § 1.72-9.[31]

> ***Example 1.*** Tim bought a fixed life annuity for $1,000,000 with payments to begin at age 65. Under Table V, Tim's life expectancy is 20.0 years. The annuity payments are $75,000/year. The expected return on the contract is $1,500,000 (20.0 x $75,000). The exclusion ratio is .667 (2/3). Thus, 1/3 of each payment is taxable

[26] Reg. § 1.72-2(b)(2).
[27] IRC § 72(b).
[28] IRC § 72(c)(1).
[29] IRC § 72(c)(3).
[30] IRC § 72(c)(3)(B).
[31] IRC § 72(c)(3)(A).

($25,000) and 2/3 is excluded ($50,000). Note that if Tim lives longer than expected and the investment in the contract is used up, all further payments are subject to tax.

All income from annuity payments is taxed as ordinary income. This is true even if the income was generated from stocks that would normally be characterized as capital gains. On the surface this may not look like a great deal, but remember that the purpose of deferred annuities is to take income from higher tax bracket years and defer it to lower tax bracket years. Therefore, even though the annuity payments are taxed as ordinary income, the income will be taxed at a lower rate than it would have been had a deferred annuity not been purchased.

The tax treatment of non-annuity payments (cash withdrawals, loans and dividends) depends on when the payments are received. If such payments are received on or after the annuity starting date they are fully taxable.[32] If they are received before the annuity starting date they are taxable only to the extent they exceed the cost of the contract (i.e., accumulated premiums paid).[33] For purposes of computing the taxable portion of future non-annuity payments, non-taxable amounts reduce the cost of the contract.[34]

Taxation of Variable Annuities

Since annuity payments from variable annuities will fluctuate based on the performance of the underlying investments, the payments are taxed differently than those from fixed annuities. The nontaxable portion of each payment is constant over the term of the annuity. It is calculated by dividing the investment in the annuity contract (adjusted for any refund feature) by the number of expected periodic payments. Any portion of each payment that exceeds this amount is taxable as ordinary income. If the annuity payment is less than the recovery portion of the basis, in later years the taxpayer may elect to re-compute the nontaxable amount. If such an election is made, then the portion of the basis that was not recovered in the earlier year is spread out over the remainder of the annuity contract term. Once the nontaxable portion (or basis) has been completely recovered, any additional annuity payments are fully taxable.[35]

Example 2. Taxpayer (T) purchased a variable annuity for $150,000. T retires at age 70 and begins taking annuity payments based on his life expectancy. At this time, the value of the annuity contract is $200,000. T receives an annuity payment of $12,500 in the first year of the annuity. The taxable amount is calculated as follows:

Cost of the Annuity Contract	$ 150,000
Life Expectancy Multiple for Age 70 from Table V	16.0 years
Tax-Free Amount for Each Payment ($150,000 / 16.0)	$ 9,375
Amount Included in Ordinary Income ($12,500 - $9,375)	$ 3,125

[32] IRC § 72(e)(3)(A).
[33] IRC § 72(e)(3)(B).
[34] IRC § 72(e)(6)(B).
[35] Reg. §§ 1.72-2(b)(3) and 1.72-2(d)(3).

Example 3. Assume that the next year, the value of T's annuity investments decline. Since T owns a variable annuity, the amount he receives is based on the value of the contract. In Year 2, T receives an annuity payment of only $5,000. Since this is below T's nontaxable amount, none of it is taxable. Next, assume that in Year 3, the annuity investments have recovered in value and T receives $12,000. Therefore, his nontaxable amount that year is again $9,375. In addition, T may make an election to re-compute his excludable amount for the remainder of the annuity term because Year 2's payment was less than his excludable amount. The amount of nontaxable recovery of basis that was not used in the previous year is allocated over the remainder of the recovery period based on T's life expectancy at the time of the recalculation. T is now 72 years old, and therefore, has a life expectancy of 14.6 years under Table V.

= ($9,375 - $5,000) / 14.6 = $ 300

Thus, $300 of the nontaxable recovery of basis is added to the nontaxable recovery of basis for each remaining year; giving T a nontaxable amount of $9,675 per year. Therefore, in the current year T has nontaxable recovery of $9,675 and ordinary income of $2,325.

Tax Savings from Deferred Annuities

An annuity contract is a perfect investment for taxpayers currently in high tax brackets who expect to be in lower tax brackets in the future. Such taxpayers could avoid having income subject to both the 37% tax rate and the 3.8% NIIT by purchasing an annuity contract in the current year, and then later receive the annuity payments when they are in a lower tax bracket and below the applicable threshold amount for the NIIT.

Example 4.[36] Taxpayer (T), a 50 year-old filing single, has $650,000 of salary income and a $1,000,000 high-yield bond portfolio that produces $50,000 of annual interest income. T expects to have the same income for the next 15 years until he retires at age 65. T does not need the $50,000 of bond income while he is still working. After T retires, he expects to have $150,000 of annual income from his Roth IRA plus the income from the bond portfolio. Compare the following two scenarios.

Scenario 1: T does no planning. Therefore, the $50,000 of interest income is taxed at the 37% rate and at the 3.8% NIIT rate (he has NII of $50,000 and his AGI is over the $200,000 applicable threshold amount). Thus, his total tax on the $50,000 is 40.8% or $20,400 per year for the next 15 years.

After retirement, he will only have taxable income of $50,000 from the bond portfolio because the Roth IRA distribution is not taxable. Furthermore, he is not subject to the NIIT because his total MAGI isn't abovethe applicable threshold amount of $200,000 (recall that Roth IRA distributions are not

[36] All figures computed with 2022 rates.

included in MAGI). The tax on this amount, without regard to any deductions T may have, will be:

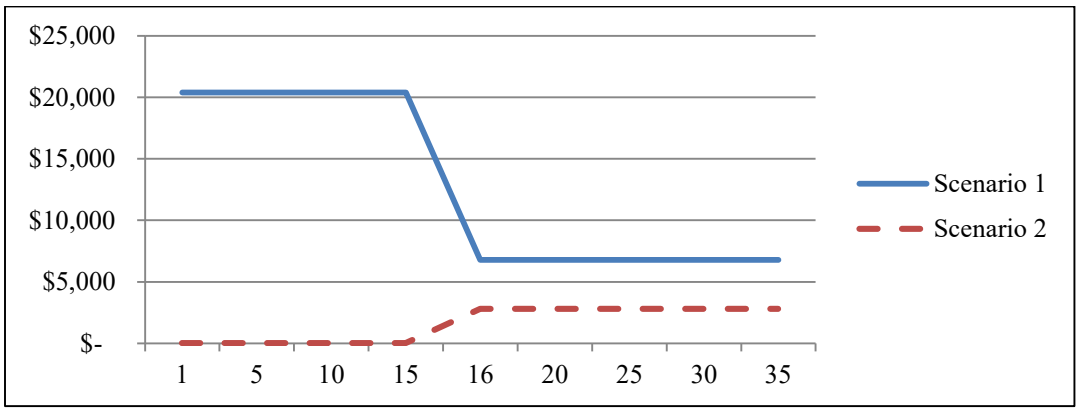
Taxable Income	Rate	Tax
Less than $11,000	10%	$1,100
Over $111,000, under 44,725	12%	$4,047
Over $44,725, under $93,375	22%	$1,160
Total:	12.61%	$ 6,307

Scenario 2: Instead, T plans and invests the $1,000,000 bond portfolio in a fixed deferred annuity. Assume that given T's age at retirement, the $1,000,000 will buy an annual annuity of $75,000 per year. In the current year, T will have eliminated any income above $578,125; thus, staying out of the highest income tax bracket. Furthermore, T will not have any NII, thereby eliminating any NIIT he might have to pay. The same result will occur for the next 15 years.

After retirement, T will have total income of $175,000 per year ($75,000 annuity payment and $100,000 Roth IRA distributions). Therefore, T's MAGI will be below the $200,000 applicable threshold amount (recall that Roth IRA distributions are not included in MAGI); and thus, not subject to the 3.8% NIIT. Given T's life expectancy of 20 years, T's expected return is $1,500,000, giving him an exclusion ratio of 2/3. This makes T's total taxable income after retirement $25,000 ($75,000 x 1/3 included). The tax on this amount, without regard to any deductions T may have, will be:

Taxable Income	Rate	Tax
Less than $111,000	10%	$11,000
Over $11,000, under 44,725	12%	$ 1,680
Total:	11.12%	$ 2,780

Below is a line graph demonstrating the taxes paid on that bond portfolio income under the two scenarios:



Assuming a 7% opportunity cost of capital, the present value of the $20,400 tax payments on the $50,000 of annual bond income for years 1-15 aas of time 0 is $185,801. In addition, for years 16-35, also as of time 0, the present value of the $6,307stream of tax payments is $24,217. Therefore, under Scenario 1, the present value of the total tax payments is $210,0186. By contrast, the present value of the $2,780 tax payments on the $75,000 of annuity income for years 16-35 is $10,674 under Scenario 2 (the present value of tax payments for years 1-15 is zero). Thus, the taxpayer saves $199,344 in present value terms by going with Scenario 2 instead of Scenario 1.