CAPTRUST

Annuities: Traps for the Unwary

Annuities are fairly straightforward products as far as taxation is concerned. To the extent that a distribution is considered a return of your investment in the contract, no income tax is due; to the extent that a distribution is considered earnings, income tax is due (ordinary, not capital gains). In addition, a distribution taken before age 59Â½ is subject to a 10 percent early withdrawal penalty tax on the earnings.

However, there are several ways to trigger an unexpected taxable event. Such an event can happen when you transfer the ownership of an annuity, or if your corporation purchases an annuity. You should also be aware of the rules regarding the taxation of annuity payments made to your beneficiaries.

Gifts of Annuity Contracts

If you own an annuity and give it to another individual as a gift, special income tax rules apply. You (the donor) are considered to have surrendered the contract and are subject to tax on the difference between the value of the contract (the cash surrender value) and the amount you have invested in the contract. So, if you’ve made a $70,000 investment in the contract, and the contract is worth $100,000 at the time of the gift, you would be subject to income tax on $30,000 (you would also be subject to regular gift tax rules on the entire $100,000 gift). Note that there is no taxable liability to the person who receives the annuity.

Non-Natural Persons

The non-natural person rule applies to deferred annuity contracts owned by corporations, trusts, and other entities.

The rule provides that if a nonhuman entity owns an annuity contract, the buildup in the contract is taxable each year to the owner, thus defeating the tax benefits of annuity ownership.

The rule has many exceptions, though, and does not apply to many common situations. For example, it does not apply where the estate of a deceased annuity owner owns the annuity. It also does not apply when an IRA or a qualified retirement plan owns the annuity contract.

In addition, there is an exception when a non-natural entity owns an annuity contract as *agent for a natural person*. This rule has been applied to annuity ownership by the trustees of trusts for the benefit of individuals.

Clearly, a tax professional should be consulted before putting any annuity into a trust.

Beneficiaries and Taxes

Payment after annuitization: In cases where the annuitant dies while receiving benefits under a term-certain annuity payout (i.e., payments continue for a given period of time even after the annuitant dies), the remaining payments are made to the beneficiary. The beneficiary is subject to the same tax rules as was the annuitant. A portion of each payment is considered a return of your investment in the contract, for which no income tax is due; and a portion of each payment is considered earnings, for which ordinary (not capital gains) income tax is due.

Payments before annuitization: In cases where the annuitant dies before annuitization (i.e., during the accumulation phase), any gain in the contract is recognized, and taxes are due on that amount. If the owner and the annuitant are the same, the estate of the owner will owe ordinary income taxes on the gain, and the annuity value will be included in the estate. The estate will be entitled to a tax deduction on the decedent’s final income tax return for the additional estate tax (if any) attributable to the annuity value on the decedent’s estate tax return.

If the annuity proceeds are paid to a named beneficiary, the tax on the gain in the contract is transferred to the beneficiary. The beneficiary will be entitled to a tax deduction on the beneficiary’s current income tax return for the additional estate tax (if any) attributable to the annuity value on the decedent’s estate tax return.

Source: Broadridge Investor Communication Solutions, Inc.