



## **FAQ's on Partial Annuitization**

### **What kind of annuities does this change apply to?**

The legislation does not change the tax treatment of annuities that are purchased through an employer-sponsored retirement plan such as a 401(k) plan or a 403(b) annuity plan. This is the case regardless of whether such a plan is sponsored by a small business employer, a large business employer, or any other type of employer. The provision also does not apply to amounts received under an individual retirement arrangement (i.e., an IRA).

Rather, the provision applies to deferred annuities that individuals purchase with after-tax money from a life insurance company. These types of annuity contracts are sometimes called "individual annuities" or "non-qualified annuities" (the latter denoting the fact that the contracts are not issued in connection with any type of "qualified" retirement plan such as a 401(k) plan). It is notable that only about half of American workers have access to any type of employer-sponsored retirement plan.

There was no need to change the law applicable to annuities used in connection with employer plans and IRAs because current law for those arrangements already contains a similar rule.

Does it apply to existing deferred annuities, or only those purchased going forward?

The provision applies to "amounts received" after December 31, 2010. Thus, it applies to existing deferred annuities that are partially annuitized after that date. It also applies to deferred annuities that are purchased and partially annuitized after that date.

### **How this new law affects taxation of annuities:**

To understand how the new law affects the taxation of individual annuities, it will be helpful to understand how current law works. Please note that this discussion is limited to individual annuities; different rules apply to distributions from qualified retirement plans and IRAs.

Prior to the time that a deferred annuity contract is "annuitized" and periodic annuity payments commence, distributions are taxed under an "income-first" rule. In other words, such distributions are fully taxable until all the gain in the contract has been withdrawn. Only after all the gain has been withdrawn can the owner recover his or her "basis" (or premiums) tax-free.

In contrast, after a deferred annuity contract has been annuitized and periodic annuity payments commence, the resulting payments are taxed using a pro rata rule. Under that rule, only a portion of each periodic annuity payment is taxable, and the rest is a tax-free recovery of the owner's basis in the contract. In effect, the pro rata rule allows the owner to recover his or her basis evenly over the payment period, whereas the income-first rule delays the basis recovery until all income has been withdrawn.

Under current law, there was some uncertainty whether the periodic annuity payments made pursuant to a partial annuitization were taxed under the income-first rule or the pro rata rule. Obviously, the pro rata rule is more favorable, so the possibility that the income-first rule would apply made partial annuitizations unattractive. The following numerical example illustrates how the new law clarifies this issue.

Assume that a 70-year-old male owns an individual deferred annuity with an account balance of \$60,000. Assume

further that his total after-tax premiums were \$40,000. He wants to apply half of his account balance (\$30,000) to produce a stream of fixed, periodic annuity payments that are guaranteed to continue for the longer of his life or 10 years. He wants to leave the remaining half of his account balance intact in case he has a cash emergency or to apply towards an income stream later. He takes these steps and begins receiving annuity payments of \$200 per month.

Under current law, it appears that the IRS position is that the income-first rule would apply. As a result, each \$200 monthly payment he receives is fully taxable. Assuming he is in the 25% tax bracket, his net monthly payment would be \$150. These monthly payments would continue to be fully taxable until all the gain in the contract was distributed. Although it is not entirely clear how this would be determined, it would take at least 8 years of payments – when the owner is age 78 – before he would begin recovering any of his basis.

Under the new law, the pro rata rule would apply to his annuity payments. As a result, only about \$107 of each monthly payment would be taxable, and the rest would be tax-free as a return of basis. Assuming the same tax rate as above, his net monthly payment after taxes would be \$173, i.e., about 15% higher.

NOTE: Under current law, if the individual wanted to apply half of his deferred annuity account balance towards an annuity income stream and get the benefit of the pro rata rule, he could do so but it would take additional steps and require a significant delay. Specifically, he could exchange half of his deferred annuity contract for a second, new deferred annuity contract. Under current IRS rules, it appears he then would have to wait at least one full year before he could annuitize either contract. The new law effectively eliminates the need to take this two-step approach or wait a year before commencing annuity payments.

**How this will help the typical American:**

Only about half of all American workers have access to any employer-sponsored retirement plan. As a result, there is a great need for individual annuities that Americans can purchase directly from life insurance companies. And a series of surveys conducted by the Gallup Organization and Mathew Greenwald & Associates (on behalf of the Committee of Annuity Insurers) demonstrates that the Americans who own individual annuities have moderate incomes. The most recent survey (2009) shows that 64% of individual annuity owners have annual household incomes below \$75,000, and 80% have annual household incomes below \$100,000. (The survey can be accessed at <http://www.annuity-insurers.org/annuities.aspx>.)