



## A STRATEGY SPOTLIGHT

# Taxation of Lifetime Distributions from Nonqualified Annuities

To encourage taxpayers to save for retirement, the Internal Revenue Code contains certain tax incentives that allow some taxpayers to deduct contributions to traditional IRAs and/or employer-sponsored retirement plans and avoid taxation on the earnings in those accounts until funds are withdrawn. Additionally, contributions to Roth IRAs, while not deductible, grow income tax free and, once certain conditions are met, allow for income tax-free withdrawals.

## KEY POINTS



A nonqualified deferred annuity can provide tax advantages for those saving for retirement.



Withdrawals of earnings from a nonqualified deferred annuity will be subject to income tax and, if the owner is not yet 59½, a 10% penalty may also apply.



Upon withdrawal, an annuity owner can receive a guaranteed stream of income from the annuity “annuitization” or simply withdraw from the annuity as needed.

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For retirement savers who are not eligible to contribute to the previously discussed tax-favored savings vehicles, or are constrained by the contribution limits imposed by these options, a nonqualified deferred annuity may be an attractive option. A nonqualified deferred annuity is an insurance contract where tax law imposes no limit on the after-tax amounts contributed. Additionally, earnings inside the annuity grow tax-deferred.

A nonqualified deferred annuity contract is designed to provide, at some future date, a periodic income stream over the life of an individual or over some other fixed period of time. Converting the contract value to a periodic income stream is referred to as “annuitizing” the contract. However, many owners of these contracts choose not to annuitize, but rather withdraw funds from the contract as needed during their retirement years.

Whether the annuity owner annuitizes the contract or withdraws some or all of the contract value, any earnings that are withdrawn are taxable as ordinary income. The calculation of the taxable amount differs depending upon whether the annuity is annuitized or whether the annuity owner simply withdraws from the contract.

## Taxation When an Annuity is Annuitized

When an annuity owner annuitizes all or a portion of their contract value, part of each annuity income payment received represents a return of non-taxable investment (basis) in the contract, while the balance of each payment represents taxable income. An annuity exclusion ratio is used to calculate how much of each payment is a return of basis. The exclusion ratio is determined by dividing the investment in the annuity contract (or the portion of the contract that is annuitized) by the expected return, or total payments received.

Let’s look at an example. Tom owns an annuity with a \$50,000 basis and a current value of \$80,000. Tom has just reached retirement and wants to annuitize the contract. With a 20-year life expectancy, he selects an income option that will pay \$425 per month for life, providing a projected cumulative payout of \$102,000.

Now let’s calculate what percentage of the \$102,000 is taxable and what percentage is nontaxable. The exclusion ratio of 49% is calculated by dividing the \$50,000 basis by the \$102,000 projected cumulative payout. The nontaxable portion of each \$425 monthly payment received in the first 20 years is \$208.25 ( $\$425 \times 49\%$ ), with the remaining \$216.75 subject to ordinary income tax. Starting in the 21st year until death, the full \$425 monthly payment will be taxable income since the entire basis in the contract would have already been returned to the annuity owner.

## Taxation of Withdrawals

A nonqualified deferred annuity grows tax deferred until the contract is annuitized (discussed previously) or withdrawals begin. Withdrawals from nonqualified deferred annuities are deemed to come from earnings first and then from the investment or basis in the contract.

Let's assume John, at age 55, invests \$50,000 into a nonqualified deferred annuity. Ten years later, at age 65, when the value of the contract has grown to \$90,000, he withdraws \$45,000 for a down payment on a condominium in Florida. The taxation of the withdrawal would be calculated as follows: the \$40,000 of earnings would be subject to ordinary income tax, and the remaining \$5,000 would be a tax-free return of basis.

After the withdrawal, the basis in the contract would be reduced to \$45,000. Two years later, when the cash value of the contract had increased to \$49,000, John withdraws an additional \$3,000 from the contract. Since the gain at the time of the withdrawal is \$4,000, the full \$3,000 withdrawal will be taxed as ordinary income. The basis in the contract would remain at \$45,000.

Another annuity tax rule that may affect the taxation of withdrawals is aggregation. All deferred annuity contracts issued by the same company, to the same owner, during the same calendar year will be aggregated together and treated as one contract for purposes of computing the taxable amount of distributions from any of those annuities.

For example, let's assume Sally owns two annuities purchased from the same company in the same calendar year. One annuity has a basis of \$50,000 and value of \$100,000, and the other has a basis of \$50,000 and value \$55,000. Sally wants to withdraw \$20,000. Without aggregation, she can withdraw the entire \$20,000 from the lower value annuity and only be subject to tax on \$5,000. However, aggregation combines the two annuities, so there is a total of \$55,000 of gain. Therefore, the entire withdrawal of \$20,000 would be subject to taxation.

As previously stated, annuity withdrawals are taxed on an "earnings first" basis. However, there is an exception to this rule for annuity contracts that were purchased prior to August 14, 1982. For these contracts, earnings are taxed last. In other words, withdrawals first come from the tax-free basis in the contract and only when basis is exhausted will distributions of taxable gains in the contract be taxed.

## Premature Distribution Penalty

A 10% tax generally applies to the taxable amount of withdrawals from nonqualified deferred annuities made before the owner attains age 59½. However, several exceptions apply to this tax, including but not limited to withdrawals made:

- 1 | As a result of an annuity owner's death.
- 2 | As a result of the annuity owner becoming disabled.
- 3 | In substantially equal periodic payments (SEPP) over the life or life expectancy of the owner, or joint lives or joint life expectancies of the owner and a designated beneficiary.

The SEPP exception applies to periodic withdrawals when the amount of the withdrawals is determined under one of three IRS-approved life expectancy methods — annuitization, amortization, and lifetime method. Once the withdrawals begin, they must continue for five years or until the annuity owner reaches age 59½, whichever is later.

For the SEPP exception to apply under the annuitization method, the income option selected must be based on the owner's life expectancy (or owner's and joint annuitant's life expectancies). An income option simply based on a certain period of time (e.g., 10 years) does not meet the SEPP exception.

## The Bottom Line

A nonqualified deferred annuity may be an attractive investment option for those saving for retirement who have maxed out on other tax-favored retirement savings vehicles such as employer qualified plans or IRAs.

While the annuity earnings that remain in the contract grow tax deferred, eventually many deferred annuity investors will need to withdraw funds from their annuity to supplement other sources of retirement income. It is important for the deferred annuity owner to understand the options they have to access these funds and the tax implications of these options.

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