

Annuity Advisor

A Journal For Annuity Professionals

April 15, 2011

SPIA Taxation

In recent years, Single Premium Immediate Annuities (“SPIA”) have gained new respect as a method of converting a sum of money into a periodic income, either for a specific period of time or for the life expectancy of one or two individuals. Because of the increased popularity of SPIAs, this month’s edition will serve to refresh our memories about how the income is taxed.

Basic Rule

For fixed annuities providing non-varying income, an *exclusion ratio* must be determined for the SPIA contract. The exclusion ratio (which is expressed as a percentage) is then multiplied by each income payment to determine the amount that is excludible from gross income. The balance of the payment is included in gross income for the year in which it is received.

The purpose of the exclusion ratio is to allow a pro-rata portion of the *investment in the contract* (generally, the cost basis of the contract that represents after-tax money) to be recovered over the payout period. For contracts on which the income starting date is after December 31, 1986, once the investment in the contract has been fully recovered, the exclusion ratio is no longer applied to each payment: The entire income payment will be included in gross income. If the income starting date was before January 1, 1987, the exclusion ratio will continue to apply, even after the investment in the contract has been recovered.

The exclusion ratio is determined by dividing the investment in the contract by the *expected return*. The quotient is rounded to the nearest 1/10%.

Investment in the Contract

Generally, the investment in the contract is the premium paid. In the case where an SPIA is being purchased with non-qualified funds that have already been subjected to income taxes, the investment in the contract is the premium, but may be adjusted for certain guarantees in the SPIA, discussed below. In the case where qualified funds are being used to purchase a SPIA to provide income, the investment in the contract is generally zero, since none of the funds have yet been taxed. (Where qualified funds also contain after-tax contributions, special rules that are beyond the scope of this article apply.)

If the cash value of a non-qualified deferred annuity or a life insurance policy is being used to purchase the SPIA income, the investment in the contract is the premium(s) originally paid. If the original policy contained any supplementary benefits, such as accidental death benefit, disability income benefit or waiver of premium, the cost of those benefits must be deducted from the premium cost when determining the investment in the contract. Additionally, for tax years after 2009, a charge against the surrender value of a contract to provide for a premium payment of a qualified long term care contract will reduce the investment in the contract, but only if the contract was issued after 1996.

Adjustments to Investment in the Contract

If the annuity income has a refund option or a period certain guarantee, an adjustment must be made to the investment in the contract to reflect the value of the applicable feature. For example, if the annuity income is for life with a guarantee that payments will be made for at least 10 years should the annuitant die before

120 monthly payments have been made, the cost of providing that 10 year guarantee must be deducted from the investment in the contract when calculating the exclusion ratio.

This adjustment is calculated using tables provided by the Income Tax Regulations in §1.72-9¹. Specifically, Table VII contains percentages based on the age when annuity payments begin and the length of the guarantee. The appropriate percentage is multiplied by the smaller of (a) the investment in the contract or (b) the total guaranteed return provided by the contract. This amount is then deducted from the investment in the contract, resulting in an adjusted investment in the contract to be used in the exclusion ratio calculation.

Expected Return

As the term implies, this is the amount expected to be paid from the annuity as income. In the situation where payments are for a fixed period with no life expectancies involved, the expected return is simply the sum of all guaranteed payments to be made. For example, if the annuity provides for \$1,000 per month to be paid over five years, after which time payments stop, the expected return is \$60,000 (\$1,000 times 12 pymts/yr times 5 yrs).

If payments are to be made for the life expectancy of an individual or the joint life expectancies of two persons, the expected return is determined by multiplying the sum of one year's payments by the applicable life expectancy or expectancies. The life expectancy factors must be taken from tables provided in the Income Tax Regulations cited earlier².

Examples

Example 1. A 65 year old purchases a non-qualified 5 year term certain SPIA with a premium of \$25,000. The monthly income is \$438.

The investment in the contract is \$25,000. The expected return is \$26,280, the sum of all 60 payments to be made under the contract. Therefore, the exclusion ratio is 95.1%, meaning that 95.1% of each monthly payment, or \$416.53, is a return of basis and is not taxable. The remaining \$21.47 of each monthly payment is included in gross income.

Example 2. A 65 year old purchases a non-qualified SPIA with a premium of \$25,000. Monthly life income is \$150.25, payable until the death of the annuitant.

The investment in the contract is \$25,000. The applicable life expectancy from the IRS tables is 20.0 years, so the expected return is \$36,060, making the exclusion ratio 69.3%. Of each payment, \$104.12 is excluded from income. However, if the annuitant lives beyond 20 years, income payments made from that point on are fully taxable, since the after-tax investment in the contract has been recovered.

Example 3. The same situation as in example 2, however, the monthly life income is reduced to \$144.75 and is guaranteed for 10 years.

In this case, the investment in the contract is adjusted by 6% (from the IRS tables) for the 10 year guarantee period. Since \$17,370 (120 monthly payments) is guaranteed under the contract, the adjustment is 6% of that amount, or \$1,042.20, resulting in an adjusted investment in the contract of \$23,957.80. The expected return is \$34,740, resulting in an exclusion ratio of 69.0%.

Summary

Insurance companies that issue SPIAs generally calculate the exclusion ratio when a contract is issued and use it for the basis of their annual reporting on Form 1099-R. However, it's a good idea for annuity professionals to have a basic understanding of how those calculations are made in order to respond to client questions. If additional information is needed, we're always here to help.

¹ These tables can also be found in IRS Publication 939 – General Rule for Pensions and Annuities. This publication also contains detailed information about the calculation of the exclusion ratio for those who are interested.

² *Ibid.*