Common Annuity Questions

Annuities are complex products. Below are the answers to some of the most common annuity questions and misconceptions. Because there can be variations between carriers and products, it's always best to verify directly with the insurance company that there isn't a unique feature with individual contracts.

Investment Products – Annuities

TAXABILITY

Are taxes paid on an annuity every year?

No. One of the benefits of an annuity is that it is a tax-deferred product. Taxes are not paid until there is a distribution from the contract.

How are annuity distributions taxed?

Annuity distributions are taxed as ordinary income. For qualified contracts, the full distribution is taxable. For non-qualified contracts, anything above cost basis is taxed as ordinary income. Distributions from a post-TEFRA contract (issued on or after 8/14/1982) will come out gains first and be taxable until down to the cost basis. Prior to 8/14/1982, gains come out last.

How are annuitized/immediate annuity payments from non-qualified contracts taxed?

Both annuitized payments and immediate annuity payments from a non-qualified contract are taxed with an exclusion ratio. A portion of each payment will be non-taxable.

LIFETIME INCOME RIDERS

Is using an income rider the same as annuitizing the contract?

No. Taking income from an annuity contract using the lifetime income rider is not the same as annuitizing the contract. Unlike with annuitization, there is still value in the annuity. In the case of a variable annuity with an income rider, the contract value is still invested in the underlying subaccounts. With annuitization, the owner no longer has control of the asset as it has just become an income stream.

What happens if a withdrawal is taken that is more than the allowable amount?

An excess withdrawal will negatively impact the benefit base and the future income amounts. It will most likely reduce the benefit base in the same proportion that the excess withdrawal reduced the contract value. This is sometimes called “blowing up the rider”.

How does an income rider affect investment options?

Although some carriers will allow full investment flexibility when an income rider is added to the contract, most carriers will restrict how much can be invested in equities. Some carriers restrict it either by the percentage that can be allocated to equities and some will require the contract value be allocated to a specific model. Each rider is different, and the investment percentage should be verified directly with the carrier.

How is the lifetime income amount determined?

Most (not all) income riders determine the income based on an income base. This income/benefit base will typically grow by a certain percentage every year for a set number of years (usually 10) or the first withdrawal. The age at the time of the first withdrawal determines what percentage of the income/benefit base can be taken every year and is typically locked-in for life. For joint income, the withdrawal percentage is typically based on the age of the younger spouse. The income/benefit base is not a value that can be withdrawn in a lump sum; it is solely used to determine the lifetime income amount.

How is the cost of the income rider determined?

The cost of an income rider is a percentage calculated off the income/benefit base value. The cost is subtracted from the contract value, not the income/benefit base.

What happens if the contract value goes to zero?

In most cases, if the contract value goes to zero the payments will continue in the same amount. There are a few exceptions, including non-lifetime benefits (such as GMIBs), if there had been excess withdrawals made, or if a benefit provision reduces the withdrawal percentage when the contract value reaches zero.

DEATH BENEFIT

What is the death benefit on an annuity?

Although it can vary by product, the standard death benefit on most annuity products is the greater of contract value or purchase payments adjusted for withdrawals. Sometimes the death benefit is contract value only, but enhanced death benefits can be added for an additional cost. Typically, the death benefit reduction for withdrawals will be proportionate, although some products will reduce it dollar-for-dollar.

When will a death benefit pay?

Some annuity contracts are owner-driven, and some are annuitant-driven. This classification determines whose death will trigger a death benefit. The insurance company can verify whether the death of the owner, annuitant or either individual will cause a death benefit payout.

What death benefit options are available to the beneficiary(ies)?

The most common death benefit options available on an annuity are lump sum, life expectancy payments (non-qualified contracts only), 10-year deferral (qualified contracts only), 5-year deferral and annuitization. Spousal continuation is also an option for a spouse who is listed as the primary beneficiary. Click here for a description of each of these options. Death benefit options can vary by carrier, product and annuity structure so it is always important to get the options directly from the carrier.

Does an annuity death claim go through probate?

No. One of the benefits of an annuity is that the death benefit can be paid directly to a named beneficiary(ies).

What happens if there is no beneficiary listed on an annuity contract?

If there is no beneficiary listed on an annuity contract, the death benefit will pay to the estate and will be subject to probate.

Is the death benefit payout taxable?

Yes. Unlike the death benefit payout from a life insurance policy, the payout from an annuity is taxable as ordinary income.

MISCELLANEOUS

Are the premiums paid into a non-qualified contract the cost basis?

Not necessarily. Cost basis travels with the annuity. If an annuity contract was opened up via a 1035 exchange the original cost basis would be the same on the new contract.

ANNUITY STRUCTURE

Can a trust be the owner or beneficiary of an annuity contract?

While a trust can be listed as the owner and/or beneficiary of an annuity contract, it's important to evaluate the potential impact of doing so. Among the potential drawbacks are the possible loss of the tax deferral benefit and limited death benefit options. The carrier can confirm how the annuity structure may impact each of these areas.

Can the ownership be changed on an annuity?

While it may be possible to change the ownership on an annuity contract, it would usually result in a taxable event. The possible exceptions are changing the ownership to a spouse or to/from a trust with the same Tax ID. It is important to confirm the tax implications with the carrier before making a change. In addition to potential tax implications, many annuity contracts will not allow for a change in annuitant.

Can the beneficiary designation(s) be changed?

Yes, the beneficiary designation(s) can be updated throughout the life of the contract. The change can only be made with the owner's authorization. Most carriers have a Beneficiary Change Request form.

ANNUITIZATION

When does an annuity contract have to be annuitized?

Although the maximum annuitization age varies by product, a common age is 95. This is sometimes referred to as the "Maturity Date" and is the age at which the client is forced to turn the contract into an income stream or surrender the contract. The maximum annuitization age should be verified with the carrier.

What annuitization options are available?

The annuitization options available on an annuity vary by product and are laid out in the annuity contract. Some common options are Single Life Only, Single Life with a Period Certain, Joint Life, Joint Life with a Period Certain and Period Certain Only. Oftentimes any Period Certain option elected cannot extend beyond the owner's life expectancy.

Annuities are investment vehicles designed for long-term planning. Variable annuities are subject to risk, including the loss of principal. All guarantees are based on the claims-paying ability of the insurance company. Withdrawals of taxable amounts are subject to income tax, and if taken prior to age 59 ½ a 10% federal tax penalty may apply. Neither Robert W. Baird & Co., Incorporated nor its Financial Advisors offer legal or tax advice.

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