Does your under age 60 client need income? Use a SPIA.

JAN 21, 2013 | BY RUSSELL E. TOWERS, J.D., CLU, CHFC

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Individuals under age 59-and-a-half sometimes have a need for a guaranteed stream of income due to unforeseen economic circumstances in their lives. This need can be met with the purchase of a single premium immediate annuity (SPIA), which will guarantee a fixed income for life or for a period-certain-only number of years.

The questions that arise on the taxation of this stream of SPIA income will depend on whether the SPIA is a non-qualified SPIA or a qualified SPIA within an IRA. Also, if the non-qualified SPIA is part of a Section 1035 exchange from an existing deferred annuity, this will have a bearing on whether the pre-59-and-a-half penalty tax of 10 percent will apply to the taxable part of the non-qualified SPIA. Take a look at these three scenarios and see if they fit any of your clients seeking a guaranteed income stream to enhance their cash flow until they are eligible for Social Security retirement benefits.

Scenario #1

Male, age 55

- Client needs about $20,000 per year additional income for 10 years only until age 65. Client could purchase a $200,000 “non- qualified SPIA” with cash.
- The $200,000 cash-purchase SPIA qualifies for the “immediate annuity” exception to the 10 percent penalty tax rule of IRC Section 72(q)(2)(I) that references the definition of “immediate annuity” under IRC Section 72(u)(4).

The $200,000 non-qualified SPIA purchase from a competitive carrier will have an “exclusion ratio” of 94 percent on a 10-year period-certain-only settlement option. The annual guaranteed payment is $21,274. This means that $1,276 of each payment will be taxable and $19,998 of each payment will be tax free (94 percent). There will be no 10 percent penalty tax.

Note: IRC Section 72(u)(4)(C) states that “immediate annuity” means an annuity “which provides for a series of substantially equal periodic payments during the annuity period.” This means that SPIA payout options of life only, life with a period-certain guarantee, and even a period-certain-only option, should qualify for this immediate annuity exception to the 10 percent penalty tax rule.

Scenario #2

Male, age 55

- Client needs about $20,000 per year additional income for 10 years only until age 65. Client could purchase a “non-qualified SPIA” as part of a section 1035 exchange from an existing non-qualified deferred annuity currently worth $200,000.
- Assume a non-qualified deferred annuity was originally purchased 15 years ago for $100,000 and is now worth $200,000. The client wants to do a Section 1035 exchange to a non-qualified SPIA with a 10-year period-certain-only settlement option.

The $200,000 non-qualified SPIA from a competitive carrier will have an “exclusion ratio” of 47 percent because the $100,000 cost basis of the original deferred annuity carries over on the exchange to become the cost basis of the SPIA. The annual guaranteed payment is $21,274. This means that $11,275 of each payment will be taxable and $9,999 of each payment will be tax free (47 percent).

However, the SPIA will *not* qualify for the "immediate annuity" exception to the 10 percent penalty rule based on the rationale of Rev. Rul. 92-95. In that ruling, the IRS held that the date of purchase for the SPIA is the date that the original deferred annuity contract was purchased. Hence, the SPIA does not meet the definition of an "immediate annuity" for purposes of the 10 percent penalty rule. This is because the distribution from the SPIA commenced later than one year from the date that the original deferred annuity was purchased (See IRC Section 72(q)(2)(I) and IRC Section 72(u)(4)(B)).

Also, the SPIA should not qualify for the "substantially equal periodic payment" (SEPP) exception to the 10 percent penalty rule under IRC Section 72(q)(2)(D). This is because the 10-year period-certain SPIA is *not* payable over the lifetime or life expectancy of the SPIA owner according to one of the permitted SEPP life expectancy calculation methods of IRS Notice 2004-15 for non-qualified annuities.

Therefore, each SPIA payment will also have an additional 10 percent penalty tax applied each year to the taxable amount based on the exclusion ratio. After the taxpayer reaches age 59-and-a-half, the 10 percent penalty tax will end.

Note: However, a life only or life with period-certain guarantee settlement option should qualify for the SEPP exception to the 10 percent penalty tax rule under IRC Section 72(q)(2)(D). This is because a SPIA with those payment options would be payable over the lifetime or life expectancy of the SPIA owner according to one of the permitted life expectancy SEPP calculation methods of IRS Notice 2004-15 for non-qualified annuities. However, the election of one of these permitted life expectancy SEPP methods in our example would leave the client significantly below the $20,000 target of extra income needed for the next 10 years.

Scenario #3

Male, age 55

- Client needs about $20,000 per year additional income for 10 years only until age 65. Client could purchase a "qualified SPIA IRA" as part of an IRA direct transfer of $200,000 from an existing mutual fund IRA or a deferred annuity IRA.
- Assume a client wishes to transfer $200,000 of funds from an IRA to a qualified SPIA IRA to provide additional current income from age 55 to 65. Assume the cost basis of the IRA is $0. The client wants a qualified SPIA IRA with a 10-year period-certain-only settlement option.

The $200,000 qualified SPIA IRA from a competitive carrier will have an annual guaranteed payment of $21,274. This $21,274 annual payment to the IRA owner will be 100 percent taxable income.

However, the SPIA IRA should not qualify for the "substantially equal periodic payment" (SEPP) exception to the 10 percent penalty rule under IRC Section 72(t)(2)(A)(iv). This is because the 10-year period-certain-only SPIA IRA is *not* payable over the lifetime or life expectancy of the IRA owner according to one of the permitted SEPP life expectancy calculation methods of Rev. Rul. 2002-62 for qualified plans and IRAs.

Therefore, each qualified SPIA IRA payment will also have an additional 10 percent penalty tax applied each year to the full taxable amount. After the IRA owner reaches age 59-and-a-half, the 10 percent penalty tax will end.

Note: However, a life only or life with period-certain guarantee settlement option should qualify for the SEPP exception to the 10 percent penalty tax rule under IRC Section 72(t)(2)(A)(iv). This is because a SPIA IRA with those payment options would be payable over the lifetime or life expectancy of the SPIA IRA owner according to one of the permitted life expectancy calculation methods of Rev. Rul. 2002-62 for qualified plans and IRAs. However, the election of one of these permitted life expectancy SEPP methods in our example would leave the client significantly below the $20,000 target of extra income needed for the next 10 years.