Partial Annuitization – It's About Time

On September 27, President Obama signed H.R Bill 5297, The Small Business Jobs Act of 2010, into law. The new legislation includes a number of provisions to ease tax burdens for small businesses. Also included is a welcome change to allow favorable tax treatments for partial annuitization by Americans.

Beginning on January 1, 2011, annuity contracts can take advantage of this long-awaited concept.

Under current 2010 federal tax law, and before enactment of the new law, there is no explicit allowance for partial annuitization of an existing non-qualified annuity contract. Section 72 of the Internal Revenue Code specifically discusses tax treatments to be distinctly different for 'payments received as an annuity' and 'payment not received as an annuity,' In insurance industry terminology, the former concept refers to formal contract annuitization under which a favored tax exclusion ratio can be used in conjunction with non-qualified annuity contracts. The latter concept assumes that any withdrawal or surrender from a non-qualified contract is to be taxed in the post-TEFRA harshest treatment – that is, earnings first, then principal and with penalties if under and 59 and 1/2. The two distinct concepts further assume an 'all or nothing' treatment against any given contract. In brief, there was no direct and expedient way to partially annuitize an existing contract.

In contrast to the old tax treatment rules, consumers do not normally make 'all or nothing' decisions about their investments which are intended to carry them through their retirement years. Instead, pre-retirees who are now getting educated about guarantee options offered by the insurance industry and perhaps considering annuitization may be considering an annuitization payout stream for some but not all of their assets. This 'some but not all' pattern under the old tax rules cannot be applied directly to the hundreds of thousands of dollars that have been already accumulated intact within a fixed or variable deferred annuity contract.

So what do consumers have to do today to achieve partial annuitization? They use a cumbersome process of partial 1035 exchange. In this process, part of an existing annuity contract is withdrawn and a new annuity contract is immediately issued to house the proceeds. This new contract is then annuitized. Commonly the new contract is an immediate annuity by design. This process requires multiple administrative steps and associated expenses to respect the 'all or nothing' restriction within a single annuity asset.

Under the new law, and beginning January 1 2011, a new type of transaction will be allowed – a partial annuitization. For the insurer, administrative software will have to recognize and allow for a new form of withdrawal or partial surrender request – a partial annuitization. This selection will suppress the normal 'payment not received as an annuity' logic that would otherwise apply and instead put in place the tax exclusion ratio handling that will then apply only against the part of the contract being annuitized.

Many administrative software solutions supporting annuities today at insurers only allow for one form of tax treatment within an annuity asset and simply assume the 'all or nothing' rule as a result. This restriction makes sense since the current rules have been in place since 1982. For this reason, you can expect there to be some unexpected 2010 year-end planning and software revisions to enable support of partial annuitization within a single contract. Also expect some guidance for Treasury on any reporting requirements.

Of course, a partial 1035 exchange using the old rules will still accomplish the goal, but the new rules are being allowed to assist in remedying the burdensome work-around procedures that are required to accomplish partial annuitization today.

Is your software ready and able to support partial annuitization?

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