Handling the Complexities of Planning With Annuities

Although commercial annuities are popular investments for seniors, these assets can be complex and are often misunderstood. This article explores planning with deferred and immediate annuities (including the tax aspects).

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Commercial annuities are assets commonly owned by individuals age 55 and older. With so many in this age group owning annuities as part of their portfolios, a basic understanding of how these assets work, how they are taxed and how they can be incorporated into the overall estate plan is important to the professional advisor.

What is a deferred annuity?

Commercial annuities are investments purchased from insurance companies.[1] A deferred annuity is created via a contract between the purchaser (i.e., the annuity owner) and the insurance company. The owner gives the insurance company a lump sum of money ideally, but not necessarily, with the intention of having future retirement income. The owner expects the annuity's value to grow every year while the insurance company invests the lump sum. To show the investment growth, annual reports are provided to the annuity owner.

Annuities were originally developed under the theory that purchasers would want to have an income stream when they reach retirement age. A deferred annuity can be turned into an income stream, typically at any point in time. This act of turning a deferred annuity into a steady income stream is called “annuitizing” the contract. When annuitized, the deferred annuity contract is typically replaced with a new contract called an immediate annuity or “life settlement option.” Although the deferred annuity itself can be the contract used to create the income payment, it is not often used because the amount of income offered is usually noncompetitive.

While annuities were created for income purposes, only about 1% of all deferred annuities are actually converted into an immediate annuity. The majority of deferred annuities are kept in “deferred” status, allowing their values to continue growing, still giving the owner the option to annuitize whenever he or she wants or needs. Therefore, most annuities are not providing their owners with retirement income, but are, in fact, asset accumulation vehicles.

Common deferred annuity contract features. The popularity of annuities stems from their ability to offer tax-deferred growth. It isn't tax-free growth but tax-deferred, meaning that the growth is taxable eventually, normally when withdrawn or upon death.

Annuities are most commonly funded with “nonqualified funds,” meaning after-tax funds such as amounts from savings accounts, CDs, investments, checking accounts, etc. An annuity owner can take funds in a traditional IRA and use them to purchase a tax-qualified (i.e., IRA) annuity. The latter can be created using the same contract as for a nonqualified annuity, but it becomes tax-qualified through the use of a rider on the contact. In addition to IRAs, SEPs and SIMPLE IRAs, some 401(k)/403(b) plans offer plan participants the choice of putting a portion of their pre-tax contributions into a deferred annuity. Qualified annuities have different contractual provisions and tax issues. The balance of this article discusses nonqualified annuities.

Issue ages. Commercial annuities are generally available for annuitants up to age 90.

Minimum premiums. Most insurance companies require a minimum amount that an investor must deposit in order to purchase a commercial deferred annuity. Minimums usually start around $5,000 or $10,000.

Account values. A deferred annuity will declare an accumulation value, which is the value of the annuity typically as of the end of the last policy year without any reduction for surrender charges. The surrender value equals the accumulation value minus the current year's surrender charge. The guaranteed value, a third amount that may be declared, is the value based on the annuity credited with the guaranteed minimum interest in the annuity contract. To illustrate, an annuity might have an accumulation value of $100,000, a surrender value of $93,000 and a guaranteed value of $80,000. The accumulation value and the surrender value should be equal once the annuity has been owned long enough to be beyond the surrender charge period for that particular annuity contract, because at that point, the surrender charge is zero.

Withdrawals. Most deferred annuities offer the annuity owner the right to withdraw a portion of the annuity's value each year. A withdrawal is not an annuitization option. The annuitization option is the affirmative election of exchanging a deferred annuity into a payment stream. Once elected, it is an irreversible decision. A withdrawal is an infrequent request for a portion of the annuity value, allowing the remaining deferred annuity to remain intact. The annuity owner may withdraw amounts at any time, but surrender charges may apply.

Many annuities offer the owner the chance to take out a small percentage (e.g., 10%) each year, after the first year, without a surrender charge. Such a provision is commonly called the “free corridor.”

Surrender charges. Surrender charges are amounts the insurance company charges against the annuity owner's withdrawn amount for the ability to withdraw part of the annuity. Annuities were historically created to provide owners with the ability to save money for retirement. Hence, the insurance company prices the annuity with the idea that it will have the deposited funds for a long period of time and the insurer invests that money with a long time horizon in mind. Assessing surrender charges for early withdrawals serves as a deterrent against withdrawing too much too soon.

Surrender charge percentages are stated in the annuity contract. The surrender charge is kept by the insurance company and is not related in any way to the taxation of the annuity or penalty taxes.

Surrender charges vary widely by the type of annuity and the individual insurance company offering the annuity. Generally, the higher the charge, or the longer the number of years that charges exist, the lesser the quality of the investment to the owner. A

typical surrender charge schedule would last from five to seven years and would start at a percentage no higher than 7%, as shown in Exhibit 1. A less favorable annuity might have a surrender charge schedule as seen in Exhibit 2.

Free-look periods. The “free-look period” is a casual name given to an annuity contract provision. It typically states that the annuity owner has a certain number of days (commonly ten) to return the policy to the insurance company after the agent has delivered the policy. This contract provision allows the owner to return the policy during this period without being subject to any surrender charges.

In reality, it is often well past the free-look period when an owner questions the purchase of the annuity or has an issue that would have made him or her return it for a full refund. Not many policies are ever returned under the free-look period provision—most likely because those clients who do want to return the policy did not realize it within the free-look period.

Methods of crediting interest on deferred annuities. One of the ways commercial deferred annuities can be distinguished is how the annuity's interest earnings are determined each year. The most popular methods of crediting interest are fixed interest, equity-indexed, and variable annuities.

Fixed interest. The most basic form of annuity offers interest earnings each year based on the payment of a fixed percentage of interest. Each year on the anniversary of the annuity, the insurance company declares what rate of interest it will pay for the upcoming year—for example, it might declare that it will pay 4%. As a consumer protection feature, each annuity contract states a minimum amount of interest that can be credited each year—for example, 2%. Therefore, in this case, the insurance company cannot set the annual rate of interest below 2%.

Equity-indexed. The equity-indexed annuity is the newest of the three types of interest-crediting techniques. The annuity is still credited with interest earnings, but the insurance company looks to an outside source to determine the amount of interest to credit. Common outside sources are the S&P 500 Index, the Dow Jones Industrial Average, etc. Neither the annuity owner nor the insurance company actually invests the owner's money in the S&P 500—this is a commonly misunderstood element of the annuity. The insurer simply uses the S&P 500 Index in a formula to determine the level of interest that the insurance company will credit.

If there are losses in the S&P 500, zero interest is credited to the "account value" of the annuity. However, the annuity has a second value called the "guaranteed account value," and this value is credited with the contract's guaranteed interest rate year after year. If the owner ever surrenders the policy, he or she should receive the higher of that year's two account values—subject to any surrender charges.

Variable interest. Variable annuities are the third method for insurance companies to credit interest to a deferred annuity. A variable annuity offers two major investment selections: a general account and a separate account. The general account offers guarantees of principal and interest, and the separate account offers many subaccounts that act similarly to mutual funds. The rest of this article discusses fixed interest and equity-indexed annuities.

Number of premiums accepted. Some annuities allow the owner to put money into the policy only at the inception of the contract. No additional contributions are allowed. If the

owner wanted to invest more money with that insurance company, he or she would need to put the additional funds into a new annuity contract.

Other annuities allow the owner to make additional investments in the annuity contract at any time. Depending on the specific features of the contract, though, the additional contributions might be subject to an additional surrender charge schedule all their own.

Ownership and beneficiary issues. Each annuity typically has the following provisions:

The owner. This is the person or entity that has all legal rights to the policy. The owner has the right to surrender the policy, make withdrawals, name the beneficiary, etc.

The annuitant. This is the person whose life is the measuring life for the annuity, and hence, the death of this individual is the triggering point for the insurance company to pay the death benefit. The annuitant has no legal rights to the policy.

The beneficiary. This is the person or entity that will receive the death benefits upon the death of the annuitant. Although an annuity contract usually allows only one or two owners and annuitants, there can be many beneficiaries. The policy owner can name the beneficiary on the policy application, and retains the right to change the beneficiary at any time through the use of the company's change of beneficiary form. Clients should be counseled to avoid naming their estate as the beneficiary to prevent the proceeds from being payable to it. The reasons for not paying the death benefit to the estate are twofold: (1) there will be fewer funds in the estate to possibly become subject to the claims of creditors, and (2) it will prevent the gain in the annuity from being taxed as income at the estate level.

Commonly, the owner and the annuitant are listed on the annuity application as the same person. For example, a husband buys an annuity and names himself owner and annuitant and names his wife as beneficiary. But the owner and the annuitant do not necessarily have to be the same person. In other words, the husband could purchase an annuity on his wife's life—naming her as annuitant and naming himself as the owner and beneficiary.

A possible tax problem can occur when the owner, annuitant and beneficiary are three different people. The owner may be deemed to have made a gift of the policy proceeds to the beneficiary.[2] Consequently, planning who should be named the owner, annuitant and beneficiary is critical.

Most policies pay a death benefit upon the death of the annuitant, but some policies pay “other proceeds” if the owner dies before the annuitant. This amount might not be defined as a death benefit and, as a result, surrender charges might be assessed against the amount paid. Care must be taken if the annuity is established with an owner who is not the annuitant. Knowing how the annuity pays benefits under various death scenarios is essential.

If an annuity is not held by a natural person and if contributions to the annuity are made after 2/28/86, the annuity is taxed differently from a deferred annuity owned by an individual. Under IRC Section 72(u), the annual growth in the annuity is not tax-deferred. Instead, each year the growth is taxable to the owner. An annuity owned by a trust as agent for a natural person is an exception to this rule.[3] An annuity owned by a grantor trust is considered owned by the grantor.

Annuities by themselves will avoid probate when a beneficiary other than "my estate" is named in the policy. Accordingly, there isn't a good reason to transfer ownership of the annuity to a revocable living trust for purposes of avoiding probate because the annuity would have already avoided probate. If the client's attorney wishes the annuity to be owned by a revocable trust, careful drafting is required.[4]

Additional aspects of deferred annuities

Lifetime withdrawals/surrenders. IRC Section 72 governs the taxation of annuities. When an annuity owner takes a withdrawal from a deferred annuity, a taxable event typically occurs. Withdrawals are first taxed on any gain as ordinary income, not capital gain. This tax structure applies for annuities entered into after 8/13/82, and for contributions made after 8/13/82 into annuities entered into on or before that date.[5] This is commonly referred to as last-in-first-out, or “LIFO,” taxation. Note that life insurance policies (non-modified endowment contracts) are taxed differently from commercial annuities.

Example. An annuity originally purchased for $10,000 in 2002, with interest credited to it of $6,000, is now worth $16,000. If the annuity owner withdraws any amount up to $6,000, he will be taxed on the withdrawal as ordinary income. On the other hand, if he withdraws $10,000, he will receive $6,000 in ordinary income and $4,000 as a tax-free return of his original principal.

Amounts withdrawn from annuities entered into before 8/14/82, are taxed differently using the first-in-first-out method, or “FIFO.” The withdrawals are income tax-free to the extent of the annuity's cost basis; cost basis comes out first, and then gain. After the entire cost basis has been withdrawn, the balance of the withdrawals are taxed as ordinary income.

Withdrawals before age 59-1/2 and the 10% penalty tax. The owner of a deferred annuity is subject to both the annuity's contractual provisions and the tax law. Most notably, the annuity owner is subject to penalty taxes if the owner withdraws funds from the annuity before age 59-1/2, unless the owner meets one of the exceptions to this rule (such as distributions attributable to the taxpayer's becoming disabled[6]). The penalty tax applies to the amount withdrawn that is subject to income tax.[7]

In the above example, the annuity is worth $16,000, and the owner withdraws $10,000 at age 52. The $10,000 is taxed as follows: $6,000 of ordinary income and $4,000 of return of principal. Therefore, the $6,000 of ordinary income is subject to a penalty tax of $600, in addition to the income tax. The $4,000 that is a return of principal is not subject to the penalty tax.

Full surrender. Annuities can be surrendered prior to retirement or prior to the maturity date (typically age 95) stated in the contract, allowing the annuity owner to receive the balance of the annuity. The balance depends on several variables, including whether or not the annuity is inside or outside of the surrender charge period. If the annuity is outside of the surrender charge period, the annuity owner should receive the full accumulation value. If the annuity is still within the surrender charge period, only the surrender value will be available to the owner.

Example. An annuity was issued nine years ago and the contract states that there is a 4% surrender charge in the ninth year. The annuity owner surrenders the annuity. The accumulation value is $100,000. The surrender value is $96,000. The annuity owner will

receive $96,000, which is equal to the accumulation value minus (the accumulation value multiplied by the surrender charge), or $100,000 – ($100,000 × .04).

The same taxation rules apply to a full surrender as apply to partial withdrawals.

If the annuity is worth $16,000 and the cost basis is $10,000, when the owner surrenders it, he or she will have $6,000 of ordinary income. If the owner is under age 59-1/2, the 10% penalty tax may also apply.

Lifetime gifts of annuity assets. To determine the tax consequences of a gift of a deferred annuity contract, a distinction must be made between annuity contracts issued before 4/23/87 and after 4/22/87.

Annuity contracts issued before 4/23/87. The gift of a tax-deferred annuity contract issued prior to 4/23/87 will cause the annuity owner to recognize ordinary income in the year in which the annuity recipient receives proceeds from the contract. The amount of the recognized income equals the excess of the annuity's surrender value over its cost basis.

Annuity contracts issued after 4/22/87. If an individual holds an annuity contract issued after 4/22/87 and gives it to another person, the original owner is treated as having received an amount equal to the excess of the cash surrender value, at the time of transfer, over the investment in the contract at that time. [8] The owner recognizes income in the same year as the transfer regardless of when the recipient obtains proceeds from the contract.

Lifetime gifts to a spouse or transfers incident to a divorce. A spouse may give his or her nonqualified deferred annuity policy to the other spouse without the donor-spouse being subject to tax on the annuity's gain. This also applies to transfers of annuity policies between former spouses if the transfer is incident to their divorce. [9]

What if the annuity has been exchanged under Section 1035? Annuity owners frequently move commercial deferred annuities from one insurance company to another for various reasons. The owner is allowed to move his or her investment on an income tax-free basis under Section 1035. When this transaction occurs, the new annuity succeeds to the status of the prior annuity with respect to computing taxation. Accordingly, in these situations it is important not just to validate the date on which the new annuity was issued, but also to determine the issue date of the previous annuity.

Death benefits. Annuities are taxed differently from other assets. Not only are lifetime withdrawals a taxable event to the owner, death proceeds are taxable to the beneficiary to the extent there is growth in the annuity—making annuities tax-heavy assets to inherit.

Proceeds left to the surviving spouse. Most annuities allow a surviving spouse to continue owning the annuity in his or her name, if the deceased spouse owned it and predeceased the annuitant. This assumes the surviving spouse was the beneficiary, successor owner, joint owner or annuitant. For example, assume that a husband owns the annuity and names his wife as annuitant. If the husband dies first, the wife can continue with that annuity as the new owner. This is generally a contractual provision as well as an IRC provision from Section 72(s)(3). If the spouse chooses to move that annuity into her own or his own name, the spouse should clarify that the insurance company will not issue a new annuity contract (with a new set of surrender charges) but will keep the original annuity in force, and allow the surviving spouse to name a new beneficiary.

The ability to name the surviving spouse as the new owner/annuitant allows that surviving spouse to avoid having constructive receipt of the death proceeds and, hence, to avoid being subject to current tax on the annuity's gain. The surviving spouse as beneficiary also has the options described below.

Proceeds left to other individuals. A beneficiary does not have the ability to keep the annuity's tax-deferred status and place the annuity in his or her name. The beneficiary will be subject to ordinary income tax on the gain in the annuity over the deceased owner's cost basis. This is considered income in respect of a decedent ("IRD") and may be eligible for an income tax deduction for the estate tax paid on the annuity's value.

The options available at the *annuitant's* death are: (1) the beneficiary can take a lump-sum amount, (2) the beneficiary has five years to take the entire death benefit out of the policy, or (3) the beneficiary can opt to annuitize the policy proceeds. By choosing the third option, the beneficiary can elect to defer tax on the gain if the beneficiary elects annuitization within 60 days after the death benefit is payable. The beneficiary takes over the decedent's cost basis as part of the annuitization payments.[10] The gain will then be spread over the period of annuitization.

Example. Jane owns a deferred annuity now worth $80,000 with an original cost basis of $25,000, and she dies leaving her son as beneficiary. If he takes a lump-sum death benefit, he will have to pay income tax on $55,000 of ordinary income. Alternatively, he can leave the $80,000 with the insurance company for up to five years, or he can annuitize it within 60 days.

If the *owner* dies before the annuitant and the surviving spouse is not the annuitant or beneficiary, (1) the entire policy value must be distributed within five years of the owner's death, (2) the policy must be annuitized with a life annuity within one year of death, or (3) a lump sum must be taken.

Note that there is a difference in the death benefit options available with a nonqualified annuity and a qualified annuity.

Proceeds left to charities. Commercial annuities offer tax-deferred earnings while the owner is living, but can be tax-heavy assets when death occurs—leaving the beneficiary responsible to pay income tax on the deferred earnings. Consequently, these annuities are ideal assets for naming a charity as beneficiary to eliminate the tax burden. The benefits of leaving the death proceeds to charity are the elimination of federal income tax on the gain, the elimination of federal estate tax on the entire death benefit, and the ease of completing the change with a mere beneficiary designation.

Example. If Jane had instead named a charity as the beneficiary of the annuity, the charity would receive $80,000 and would not be subject to income tax on the gain. Further, the entire $80,000 would be removed from Jane's taxable estate for estate tax purposes. Jane could have named her son as a partial beneficiary and a charity as the other partial beneficiary. Jane cannot, however, name her son as the beneficiary of the cost basis and name the charity as the beneficiary of the taxable gain. The gain must be allocated ratably among all beneficiaries.

What is an immediate annuity?

Immediate annuities are a type of commercial annuity where the annuity owner offers to pay a lump-sum amount to an insurance company in exchange for a stream of payments

to begin within one year and payable for a certain length of time. There is no account balance or additional amounts that can be withdrawn from the immediate annuity. An immediate annuity is the contractual right to receive payments for the specified period of time.

Typical annuitization options. The policy owner has several payment choices. These choices will determine the amount of the payments, given a specific lump sum.

- *Life only.* The payments last for as long as the annuitant lives.
- *Life with X years certain (X = 5 to 30 years).* The payments last for as long as the annuitant lives. If, however, the annuitant dies before the end of the X-year period beginning with the issue of the annuity, the remaining payments throughout that time period are paid in the same manner to the named beneficiary.
- *Life with installment refund.* The payments last for as long as the annuitant lives. If, however, at the time of the annuitant's death, the cumulative amount of payments does not equal the premiums paid into the annuity, the named beneficiary will receive the balance in the same manner as the annuitant was receiving them until such time as the total payments equal the premiums paid.
- *Life with cash refund.* This is similar to the installment refund, except the named beneficiary will receive the balance of the payments in a lump sum.
- *Joint life only.* The payments will last for the lives of two annuitants instead of one, with no increase or decrease in the size of the payments upon the first to die of the two annuitants.
- *Joint life with X years certain (X = 5 to 30 years).* This is similar to the life with X years certain, except the payments will last for the lives of two annuitants instead of one.
- *Joint life with installment refund.* This is similar to the life with installment refund, except the payments will last for the lives of two annuitants instead of one.
- *Joint life with cash refund.* This is similar to the life with cash refund, except the payments will last for the lives of two annuitants instead of one.
- *Joint life and 50% survivor.* The payments last until the death of the first spouse; the surviving spouse will receive 50% of the payment amount for his or her remaining life.

Income taxation of payments and exclusion ratios. Each payment is considered, in part, a tax-free return of the owner's premium and part ordinary income, thus creating two tiers. An exclusion ratio is calculated upon issuance to determine how much of each payment is nontaxable. [11] Usually, the insurer will provide the owner with this information. For annuities issued after 12/31/86, once the owner has received tax-free payments equal to his or her cost basis, the remaining payments then become fully taxable to the owner. Annuities issued before 1/1/87, however, carry the exclusion ratio for the entire term of the annuity. [12]

Death benefits, if any, depending on the annuitization option selected. As shown above, only certain forms of immediate annuities will have payments available to named beneficiaries upon the death of the annuitant. Any of the “life only” payment structures stop making payments at the death of the annuitant, and no further payments are available to a potential beneficiary. As a result, these annuitization options do not have contractual beneficiaries. A fixed period annuity, an annuity for life with a certain number of years, and a cash or installment refund annuity have beneficiaries that must be addressed during the estate planning process. If the annuitant dies prior to the expiration of the fixed period, the expiration of the “years certain,” or before the premiums paid have been returned in the form of payments, the remaining payments can be paid to the

named beneficiary of record. The beneficiary will take over the cost basis and the exclusion ratio of the deceased owner. [13]

A chart comparing deferred and immediate annuities is shown in Exhibit 3.

Regulation of annuities

State regulation. Traditional fixed interest annuities are regulated by each state. Thus, there are 50 different sets of laws with respect to the selling and offering of annuities. Most states require an agent to have an insurance license in the state where the annuity is sold, not necessarily in the resident state of the annuity purchaser. Equity-indexed annuities were originally considered fixed interest annuities and so were regulated by state insurance departments. The Securities and Exchange Commission ("SEC") announced on 6/25/08, that it should regulate this type of annuity (see SEC Rule 151), and it intends to require those agents selling equity-indexed annuities also to have a securities license.

Federal regulation. Variable annuities are regulated differently from fixed interest annuities. Variable annuities are considered a security and are regulated not only by state insurance departments, but also by the SEC. The latter oversees and regulates the U.S. securities market. The Financial Industry Regulatory Authority ("FINRA"), formerly the National Association of Securities Dealers ("NASD"), enforces the SEC's rules and registers agents to sell variable annuities.

Criticism in the industry for marketing and sales practices of variable and equity-indexed annuities. Annuities can be complex and are often misunderstood investments—especially equity-indexed and variable annuities. Unlike the purchase of a tangible asset, clients cannot see or touch an annuity before buying one. The annuity contract is not shown or delivered to the owner until the owner has already submitted the application and paid the premium. Furthermore, the target market for annuities has been seniors who tend to be vulnerable. All these factors have created a backlash against annuities and the selling practices used by agents and insurance companies. Complaints allege (1) high commissions to encourage improper sales, (2) lack of liquidity for the owners, (3) gimmicky sales tactics, and (4) mind-numbing complexity.

One example of an improper sale involved a Florida couple in their 80s who were sold $600,000 in annuities that could not be touched for 15 years without large penalties. This case eventually resulted in a new Florida law to help protect senior citizens. The scrutiny and complaints regarding marketing and sales abuses have led many states to adopt a uniform law called the "Suitability in Annuity Transactions Model Regulation," which was developed by the National Association of Insurance Commissioners ("NAIC").

Conclusion

Commercial annuities may be commonly owned by seniors, but due to the complexity, these investments are not well understood by their owners. A basic understanding of annuities—whether deferred, immediate, fixed interest, or indexed—and how these assets can work in the owner's estate plan becomes crucial knowledge for the estate planning professional.

PRACTICE NOTES

Not only are lifetime withdrawals from an annuity a taxable event to the owner, death proceeds are taxable to the beneficiary to the extent there is growth in the annuity—making annuities tax-heavy assets to inherit.

Exhibit 1. Typical Surrender Charges

Annuity Contract Year	Surrender Charge (As a Percentage of Amount Withdrawn)
1	7%
2	6%
3	5%
4	4%
5	3%
6	2%
7	1%
8 and later	0%

Exhibit 2. Unfavorable Surrender Charges

Annuity Contract Year	Surrender Charge (As a Percentage of Amount Withdrawn)
1	16%
2	15%
3	14%
4	13%
5	11.5%
6	10%
7	8.5%
8	7.5%
9	5.5%
10	4%
11 and later	0%

Exhibit 3. Annuity Comparison

Feature	Deferred Annuity	Immediate Annuity
Subject to state regulation	Yes, in all states by the department of insurance; variable annuities by the SEC.	Yes, in all states by the department of insurance.
Possible to name a beneficiary upon death	Yes.	Depends on annuitization option.

Annuitization options	Annuitized payouts aren't made while the annuity is a 'deferred' annuity; policy owner would need to change to an immediate annuity.	Many options available: Life only. Life with X years certain (5 to 30 years). Life with installment refund. Life with cash refund. Joint life only. Joint life with X years certain. Joint life with installment refund. Joint life with cash refund.
Payment rates	See above.	Established by each individual insurance company; no ability to negotiate.
Can the owner shop around for the best interest rate?	Yes.	Yes.
Taxation of annuity payments	Annuitized payments are not available, but owner could take a partial withdrawal. Gain taken out is subject to ordinary income tax.	Two-tier system (ordinary income and tax-free return of principal) established by an exclusion ratio.
Potential assets for funding	Cash.	Cash.

Can it be funded with long-term appreciated assets and avoid up-front long-term capital gains tax?	No, can fund only with cash.	No, can fund only with cash.
Can the annuity hold IRA or other pretax dollars?	Yes.	Yes.
IRS penalty tax applies if funds are withdrawn prior to age 59-1/2 and an exception doesn't apply?	Yes.	Not if annuitization payout is one of the life options; would apply to a fixed term annuitization option.
Can one transfer the annuity income tax-free to another annuity under §1035?	Yes, very frequently done but only between deferred annuities. (For IRA-funded deferred annuities, it is called a rollover under §408(d)(3) and not under §1035.)	No, once the annuity is annuitized, it is typically not exchangeable to another insurance company.

[1] Banks also offer commercial annuities to individuals, but the bank is acting as a seller for the insurance company.

[2] Goodman, 34 AFTR 1534, 156 F2d 218, 46-1 USTC ¶10275 (CA-2, 1946).

[3] Section 72(u)(1).

[4] See also Ltr. Ruls. 9204014, 199905015, 9752035, 9639057, and 199933033.

[5] Section 72(e).

[6] See Section 72(q).

[7] *Id*.

[8] Section 72(e)(4)(C).

[9]

[10] Section 72(e)(4)(C)(ii).

[11] Section 72(h).

[12] Section 72(b)(1).

[13] Section 72(b)(2).

See Reg. 1.72-11(c)(2), Example 4.