July 15, 2010
Pennsylvania Inheritance Tax
No. INH-10-002
Taxation of Annuity

ISSUE

Whether a retirement account characterized as an "annuity" by the provider is exempt from Pennsylvania Inheritance Tax as life insurance where the account provides for annual payments of interest to a seventy-seven year old owner within the first thirty days the account was opened, as well as annual non-penalized distributions of principal after the first year the account was opened, and does not involve risk shifting or risk distribution on the part of the provider?

CONCLUSION

A retirement account characterized as an annuity that allows for regular payments to the annuitant and that does not involve any element of risk on the part of the provider is not life insurance and consequently, subject to Pennsylvania Inheritance Tax.

FACTS

In 2006, at the age of seventy-seven, Taxpayer purchased an annuity investment product. Taxpayer was listed as the owner of the annuity and her son was listed as sole beneficiary. The terms of the annuity provided for an initial lump sum premium deposit by Taxpayer, and a guaranteed effective interest rate of 4.25 % for five years. The minimum guaranteed rate for the plan was 3% and was effective for the life of the policy.

Taxpayer's withdrawal rights provided for unlimited withdrawal of income after the first thirty days of the policy and withdrawals of up to 15% of the total value of the annuity annually without penalty. For withdrawals of greater than 15% annually, Taxpayer would incur a withdrawal charge of up to 9% during year one of the agreement, reduced to 5% by year 5 and 0% thereafter. Taxpayer did not receive any distributions during the remainder of her lifetime. Taxpayer died in 2010. At issue is whether the date of death value of the proceeds within the account are exempt from Pennsylvania Inheritance Tax as life insurance proceeds.

DISCUSSION

Section 2111(d) of the Inheritance and Estate Tax Act of 1991 states that all proceeds of life insurance on the life of the decedent are exempt from Pennsylvania Inheritance Tax. 72 P.S. § 9111(d). Department regulation defines life insurance contracts as:

A contract possessing features of risk shifting and risk distribution, between the holder of a policy and an insurance company under which the company agrees, in return for the payment of premiums, to pay a specified sum to the designated beneficiaries upon the death of the insured.

61 Pa. Code § 93.131(b).

Federal law also addresses the primary characteristics of a life insurance policy and what distinguishes life insurance from annuities. See, generally, Treas. Reg. § 20.2039-1(d) (26 C.F.R. 20.2039-1); § 20.2042-1 (26 C.F.R. 20.2042-1). The Commonwealth's Department of Insurance has not defined life insurance. As Pennsylvania Courts have noted, an inquiry into the donative intent of the decedent is relevant, and the use of the word "annuity" in a contract is not dispositive of the issue. Estate of Dwight, 389 Pa. 520

(1957).

As the Pennsylvania Supreme Court in Bayer's Estate, 345 Pa. 308, 313 (1942) also noted:

Life insurance is an agreement to pay to a person indicated, a certain sum upon the death of the insured; the endowment provision adds thereto a contract to pay to the insured himself a specified sum provided he lives to a certain age. Life insurance is for protection against the adversity of death; endowment is based upon the contingency of survival, and is essentially a form of investment.

Id.

The Bayer Court examined a number of relevant factors in determining whether a product was life insurance or an annuity such as whether the decedent had an intention to receive the property during their lifetime, the age of the decedent at the time of purchase and whether the product delayed payment for a period of years well beyond the decedent's life expectancy. Id.

Here, Taxpayer purchased the product at the age of seventy-seven. No information is provided that would suggest Taxpayer's life expectancy was diminished in any way. While not dispositive of the issue, it is significant that the provider markets the product in question as an annuity. Further, the agreement notes that the provider's annuities generally "do provide other features and benefits, such as death benefits and income payment options," which supports the presumption that the annuity in question is not life insurance.

Finally, while Taxpayer did not receive any payments during her lifetime, Taxpayer possessed the right to receive payments of principal and income up to the maximum amounts provided for in the agreement. As such, the policy in question is more akin to an annuity rather than life insurance, and should be reported on a timely filed Pennsylvania Inheritance Tax return.