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Tax Planning for Annuities

Of course, any information pertaining to taxes is complex, full of exceptions, and subject to change. This discussion deals with the general rules for taxation of annuities—you should consult a tax advisor for more specific information before you take any action.

Favorable tax treatment is one of the main reasons for buying an annuity. But what exactly are the tax benefits? And are there any drawbacks? It's important to know the answers to these questions before deciding whether to purchase an annuity.

Of course, any information pertaining to taxes is complex, full of exceptions, and subject to change. Annuities may be funded with after-tax dollars, or they may be purchased within a tax-advantaged plan such as an IRA or 401(k). This discussion deals with the general rules for taxation of annuities funded with after-tax dollars—you should consult a tax advisor for more specific information before you take any action.

Taxation of Premiums

The after-tax money you pay into an annuity (in the form of premiums) is nondeductible. By placing funds in an annuity, you will not realize any current income tax savings, which you might receive by putting money into a traditional IRA, 401(k) plan, or other employer-sponsored retirement plan.

Tax-Deferred Growth

Unlike most investments, an increase in the value of an annuity from interest is not currently taxable. Generally, annuity funds are allowed to grow tax deferred until they're distributed, at which time the owner will pay ordinary income tax on all gains.

Taxation of Premature Withdrawals

Withdrawals taken before age 59 1/2 may be subject to a 10 percent IRS penalty tax unless an exception applies. When you make a withdrawal from an annuity, the IRS assumes that earnings are withdrawn first. The 10 percent penalty applies to the earnings portion of a withdrawal. So, early withdrawals are costly from a tax standpoint.

For example, if your annuity has grown by \$1,000 since you purchased it, a \$500 withdrawal would be considered 100 percent interest and would be subject to the 10 percent penalty—in this case, \$50. In addition, because the entire withdrawal represents earnings, it would be subject to ordinary income tax. If you are in the 25 percent tax bracket, your income tax liability on the withdrawal would be \$125. Adding this to the early withdrawal penalty, \$175 of your \$500 withdrawal would end up in the IRS's pocket.

Taxation of Scheduled Distributions

If you choose an annuitization option, you will begin receiving regular distributions from your annuity over a predetermined period of time. Each distribution consists of two components: principal (a return of the money you paid into the annuity) and earnings. The percentages of principal and earnings of each distribution will depend on the annuitization option chosen. Again, the earnings portion of each distribution will be treated as ordinary income. Also, depending on the annuitization option chosen, the 10 percent penalty rule may not apply.

Note: Annuity guarantees are subject to the claims-paying ability of the annuity issuer.

Note: Variable annuities are long-term investments suitable for retirement funding and are subject to market fluctuations and investment risk including the possibility of loss of principal. Variable annuities contain fees and charges including, but not limited to, mortality and expense risk charges, sales and surrender (early withdrawal) charges, administrative fees, and charges for optional benefits and riders. Variable annuities are sold by prospectus. You should consider the investment objectives, risk, charges, and expenses carefully before investing. The prospectus, which contains this and other information about the variable annuity, can be obtained from the insurance company issuing the variable annuity, or from your financial professional. You should read the prospectus carefully before you invest.

Taxation of Lump-Sum Distributions

Taking a lump-sum distribution of your annuity funds can have many consequences. If you make this election within the first few years after purchasing your annuity, you may be subject to surrender charges imposed by the issuer. In any case, the earnings portion of the distribution will be treated as ordinary income in the year you take the distribution. Also, keep in mind that a large lump-sum distribution could actually push you into a higher tax bracket, dramatically increasing your tax liability.

Source: Broadridge Investor Communication Solutions, Inc.

Have questions? Need help? Call the CAPTRUST Advice Desk at 800.967.9948 or [schedule an appointment](#) with a retirement counselor today.