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The New Finance Of Longevity

Annuities & Taxes

While they are designed to provide a steady income stream during retirement, their tax benefits are desirable too

by John Williams

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Tax season is often a time when people more seriously consider their future financial plans. Reviewing how their money was spent and saved from the previous year can lead one to consider new options for the future. Add to that the financial uncertainties created by the ongoing pandemic, and many are taking into account income strategies they may not have previously considered.

Annuities are designed to build savings and provide income for retirement through guaranteed returns and tax deferrals. Fixed deferred annuities have some unique tax advantages for those just beginning to make a plan for retirement, or for people who are looking for ways to bolster their retirement income.

Popular Annuity Benefits

For those approaching retirement age, or newly retired, saving for the future can feel even more pressing. One of the primary benefits of a fixed deferred annuity is it can be converted to a payment stream. Whether a client selects a 3, 5 or 10-year guarantee period for their deferred annuity, this payment stream can then help meet monthly income goals. Annuities build and protect clients' assets by offering compound growth and tax-deferral while protecting their investment from market volatility. This means that no matter what happens in the market during the chosen annuity duration, the annuity's principal is protected, as is the guaranteed minimum interest rate.

Fixed annuities are really a long-term savings plan that provide future income to supplement retirement income. Longer term annuities pay more because annuity providers can use those funds to make longer term investments (which generally pay higher returns), and then pass the higher yields on to their clients. Educating clients about this may encourage them to think long term about their savings plan.

Annuity Tax Advantages

While an annuity can provide a steady income stream during retirement, the tax advantages associated with deferred annuities also provide additional value. While tax benefits are not solely the determining factor of whether a fixed deferred annuity is right for a client, it is a meaningful one to help them better understand all of the positive attributes associated with annuities.

Annuities can be purchased with tax-qualified or nonqualified funds. For nonqualified annuities, the amount a client contributes to an annuity is not taxed, and neither is the interest earned, until money is withdrawn. For qualified annuities, the entire amount is taxed when withdrawn. Deferring taxes helps accelerate the savings growth through triple-compounding, which includes earning interest on the principal, interest on the interest and interest on what would have been paid to taxes. Advisors should have some familiarity with IRC Section 72 of the tax code, which stipulates the specific income tax ramifications when an owner takes money from an annuity, to help clients understand certain benefits.

It may be important to note that partial withdrawals from an annuity in the accumulation phase are taxed on a last in, first out (LIFO) basis. In other words, withdrawals from an annuity are made on earnings first, and the owner is taxed on the payments until all of the earnings have been distributed. Once money is withdrawn, earnings are taxed at the client's regular income tax rate — the money itself taxed like ordinary income as payments from the annuity are received.

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This in turn can provide another benefit. If a client invests in an annuity when they are working and likely have higher income, and consequently a higher tax rate, they will defer paying taxes at that higher rate. Since the client will pay taxes on the future annuity payments, after they are retired, they will not be receiving a salary and likely will be earning less overall and paying taxes at a lower rate. Thus, they will save on taxes.

Assuming a client's future tax bracket is going to be the same or lower than what it is now, this deferral is incredibly beneficial. If a client expects their tax bracket to be higher in the future, then the value of tax deferral isn't as big as it would otherwise be, which is something to talk through during early discussions.

There are a few tax rules clients should be aware of. Withdrawals of earnings from an annuity are fully taxable at ordinary income tax rates. Also, if a client is under the age 59 1/2 when they make the withdrawal, they may be assessed a 10% penalty on any taxable earnings.

Comparisons with Other Savings Strategies

Other savings options, such as money market accounts, savings accounts, certificates of deposit (CDs) and many bonds, create taxable incomes. On the other hand, annuity's tax deferral options mean clients do not have to pay on the gain until they start withdrawing funds. Additionally, with annuities clients are able to tuck away their money for a fixed amount of time and know exactly how it will perform. Other options do not quite offer the ease or peace of mind that annuities can provide.

While there isn't necessarily a "right time" or best time to purchase an annuity, clients may be more receptive during tax season when they're already thinking about the impact of their strategies and how taxes are affecting their current income. This provides advisors with a great opportunity to share how a fixed deferred annuity can be an excellent investment that provides clients with a tax-deferred income stream during their retirement years. ❖