

Annuities: *Tax Planning*

What is an Annuity?

An annuity is a savings vehicle often used for retirement purposes. It is a contract issued by a financial services company (usually, an insurance company) that allows for tax deferral on earnings. In other words, unlike most investments, you won't owe taxes at the end of the year simply because your annuity has increased in value. Essentially, you pay money to an annuity issuer, the issuer invests the money for you, and the issuer pays out the principal and earnings to you based on the distribution option you have chosen.

There are two broad options for receiving distributions from an annuity. The first option is to withdraw money as needed (similar to a savings account). The second option is the annuitization option, whereby you'll receive a guaranteed income stream from the annuity for a specified period. Here, the annuity issuer promises to pay you an amount of money (either a fixed payout or a variable payout) on a periodic basis. An immediate annuity is one in which the distribution period begins immediately (or within one year), and a deferred annuity involves a delayed distribution starting date.

How are annuities taxed?

The taxation of an annuity is relatively simple. Generally, each payment represents a partial return of your initial investment (return of

capital), and a partial distribution of investment earnings. The portion of the payment that represents your investment earnings is subject to ordinary income tax, and the portion that represents your initial investment is not taxed.

Determining which portion is taxed

To determine the taxable amount, you must use a formula known as the "exclusion ratio." This calculation consists of your investment divided by your expected return. The expected return is based on your total payments and must be determined by referring to tables provided by the IRS.

Example(s): Assume you purchased an annuity for \$1,000 and will receive annuity payments of \$200 a year for the rest of your life. Your life expectancy is 10 years. Therefore, your exclusion ratio is one-half, or 50 percent. This means that out of every \$200 payment you receive, \$100 represents a nontaxable return of capital and \$100 is taxed at ordinary income tax rates. If you're in the 15 percent bracket, this means that you'll pay \$15 in tax during the first year and you'll have \$185 to spend. You'll have to pay tax on all of the payment in Year 11, since you recover your investment in Year 10.

If you die before you recover your investment, the unrecovered portion is deductible on your final tax return. If you purchased an annuity with a starting date prior to 1987, however, you

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may exclude the exclusion amount for as long as you receive your payments. If you die before you recover your investment in such a case, the unrecovered portion is not deductible on your final tax return.

Tax advantages

Tax-deferred growth is the primary advantage of owning an annuity; you can accumulate investment earnings without recognizing immediate tax liability. In addition, you can lock in gains without taxation.

Tax disadvantages

The primary disadvantage of an annuity is that your investment earnings will eventually be taxed at ordinary income tax rates, rather than at the more favorable capital gains tax rates. In effect, you reverse normal investment tax planning by converting capital gains into ordinary income. However, this may not be quite as bad as it seems. For one thing, it is possible that you'll be in a lower income tax bracket when you start to receive your annuity payments. In addition, the tax-deferred growth should generally outweigh the increase in tax rates. Given the potential for tax-free investment growth, your after-tax return may actually be higher.

Another disadvantage is that in a variable annuity, you are not permitted to offset losses against gains. Finally, note that in a qualified tax-deferred annuity, withdrawals prior to age 59½ may be subject to a 10 percent penalty.

Planning with annuities

When it comes to retirement planning, annuities can be pretty popular because they can provide fixed income payments for life. When deciding if an annuity is appropriate for your retirement, however, consider both your need for a fixed income stream and your likely future marginal tax rate. In addition to retirement benefits, annuities can provide some investment flexibility and offer certain tax benefits.

Retirement planning strategies

Annuities are most commonly used to save for retirement. The tax-deferred nature of an annuity allows faster growth in your dollars than would a comparable taxable investment. Unlike qualified retirement plans, commercial annuities typically do not place a limit on how much you can contribute and do not have minimum distribution requirements after you reach the age of 70½. However, contributions to commercial annuities are not tax deductible; your investment must be made with after-tax dollars. And, as is the case with qualified retirement plans, withdrawals made prior to age 59½ from a qualified annuity may subject you to a 10 percent early withdrawal penalty. (Of course, this can also be the case with IRAs, depending on your circumstances and the type of IRA).

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Tax-free exchange strategies

Annuities can offer a certain amount of flexibility. It is possible to use an annuity to change investment form or ownership without causing immediate recognition of tax. For instance, you may be permitted to exchange a life insurance policy for an annuity. Generally, you can also exchange one annuity policy for another.

Strategies to increase income and limit risk

A split annuity is one strategy used to increase after-tax income and investment earnings on a fixed annuity contract while limiting risk. Generally, half of your investment is placed in an immediate annuity so that payments will commence immediately. The payments under this annuity will include both investment earnings and a return of capital. The other half of your investment is placed in a deferred annuity. This half would be expected to grow to equal the original investment over the term. Effectively, you have converted a portion of your current investment income into a nontaxable return of capital.

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