Like the great Benjamin Franklin said “a penny saved is a penny earned”! This timeless statement certainly holds true no matter how you save your money. Before Mr. Franklin ever coined this phrase, one great saving and investment vehicle was in existence, the ever popular annuity. Dating back to the early Roman Empire this product has stood strong providing thousands, even millions of dollars to the thrifty saver and planners retirement. Although there are variations in the type of annuity there are just as many crediting methods and living benefits available for annuitants.

It is important to note that when considering the purchase of an annuity the buyer should be aware of the potential tax ramifications for themselves and their future beneficiaries. These tax ramifications are based on whether your annuity is qualified or nonqualified. It is also advisable that you seek a tax advisor for your tax questions and an insurance specialist to determine which product best suits your needs and income requirements.

Why the IRS Loves Annuities

Qualified vs. Non-Qualified Annuities

Qualified Annuities

An annuity that is "qualified" is one that has received an IRS tax exempt status. This type of annuity will grow tax deferred until the age of 70 ½ at which point the annuitant must begin "taxable" withdrawals referred to as Required Minimum Distributions or RMD's. If a withdrawal is made prior to 59 ½ a 10% early withdrawal penalty is assessed in addition to ordinary income tax. The entire payment received by the annuitant from the annuity is considered ordinary income tax. Upon death If a non spouse beneficiary receives the annuity upon the annuitants death 100% of the annuity value is taxed as ordinary income to the beneficiary based on the beneficiaries tax bracket at the time of the inheritance. By inheriting this annuity the non spouse beneficiary may actually be placed into a higher tax bracket. This annuity is one of great value to the IRS for obvious "tax revenue reasons".

Non-Qualified Annuities

An annuity that is considered non-qualified is one that does not qualify for IRS tax exempt status. Although a favorable "tax revenue" asset by the IRS this is the least advantageous. Like the qualified annuity the annuitant still enjoys the benefit of tax deferral on the inside accumulation of the annuity. In addition the annuitant is not allowed to take early withdrawals without a penalty other than a 10% free withdrawal as specified in the contract. The annuitant is only taxed on the growth over and above their cost basis (the premium paid into the annuity contract) when a withdrawal is received from the annuity contract. Upon the death of the annuitant if a non spouse beneficiary is named only the growth in excess of the cost basis is considered as ordinary income to the beneficiary.

Whether qualified or non-qualified an annuity is an important savings and investment strategy that can provide a guaranteed income for life. It's up to you and your insurance specialist to determine which is right for you.