



Immediate Annuity Income Tax Issues

Overview:

The income tax issues are distinctly different, if the immediate annuity is purchased through an IRA or other qualified plan such as a 401k, 403b, 457 or other type of pension plan. You may find it efficient to skip to the sections that pertain to your situation.

Advantages and Disadvantages of Using IRA or Other Qualified Plan to Purchase Immediate Annuities:

Immediate Annuities purchased through IRA or other qualified plans (qualified annuities) receive a tax break in most states and have slightly better rates than their non-qualified counterparts. Most states impose a premium tax on insurance companies' immediate annuity premiums and many either eliminate or reduce that tax on annuities purchased by pension plans. Insurance companies pass their savings to the investor in the form of lower rates i.e. improved monthly income. For this reason, **Qualified Annuity** rates may be more favorable than Non-Qualified annuities.

IRA plan participants are required to make minimum distributions starting at age 70.5 (RMD). Any money invested in an **Immediate Life Annuity** automatically qualifies for the RMD. For those that have all of their IRA assets in an Immediate Annuity, they need not worry about the RMD as it is fully qualified. For those that have other IRA assets, they would eliminate the Immediate Annuity investment in their calculation (i.e. the RMD calculation would only be made on non-immediate annuity assets in the IRA plan(s).

Because of the RMD most IRA and Annuity plans will be liquidating the principal of the IRA over time. The RMD increases as a % of assets as one advances in age and this will result in the liquidation of the IRA principal over time. The Immediate Life Annuity assures that the income will never run out during the annuitant's lifetime, a guarantee that is not possible with other IRA investments.

Since IRA money never escapes income taxes to the beneficiaries, using it to maximize income during your lifetime makes sense as the beneficiaries will pay taxes on assets left to them from qualified plan assets such as IRA's and Annuities. In other words, beneficiaries would be better served if you left them assets that are not income taxable such as appreciated investments that get a new stepped up income tax basis at death.

The major disadvantage of using the IRA for an Immediate Annuity vs. Purchasing it with other assets is that some investors like to invest aggressively for tax deferral with their IRA and may prefer the income tax benefit of a Non-Qualified Immediate Annuity described below.

Non Qualifies Annuity Tax Benefits:

A **Non-Qualified Annuity** is one that is purchased through money that has already been income taxed and therefore becomes part of the cost basis. An Immediate Annuity payment consists of income and principal. Insurance companies are required by law for Non-Qualified Annuities to calculate a life expectancy and submit a filing of what is known as an “**exclusion ratio.**” The exclusion ratio is the percentage of the payment that is excludable from income. It represents the theoretical amount that is the return of principal. For example, the exclusion ratio of 70% means that 70% of the payment is considered return of principal and is therefore not taxed. That would mean that only 30% of the payment is taxable. For example, on a \$1,000 monthly payment with an exclusion ratio of 70%, 300 per month or \$3,600 per year is considered interest and would be the only amount included for income tax purposes. The insurance company will file the taxable portion with the IRS each year and send you a statement for inclusion in doing your tax return. In the above example, 700 per month is excluded from income. The IRS rules say that when the sum of the excludable amount (in this case \$700 per month) is equal to the original investment, then at that point on all income is taxable. This simply means that when you get credit for all of your principal for tax purposes, you have used up your cost basis and pay full income tax on the benefit going forward. In this example, let’s assume that the original premium was \$100,000. At the rate of \$700 per month in return of principal or exclusion it would be in 143 months that the principal would be gone. In the month 144 all income would be taxable.

The shorter the life expectancy is for an annuitant(s), the higher the exclusion ratio. The more guaranteed benefits such as refunds and additional years of guaranteed payments, the lower the exclusion ratio. We provide exclusion ratios with our illustrations.

Tax Leverage for Non-Qualified Annuities:

Because of the operation of the exclusion ratio, investors in high income tax brackets get more spendable income from an **Immediate Annuity** than from other forms of investments. Since annuity payments include principal payments and interest they generate more cash flow than other investments with similar risk. The exclusion of a good portion of the annuity income from income taxation makes the equivalent return much higher, for high tax bracket annuitants. The **exclusion of annuity income** is not meaningful for those that do not pay income taxes.