

## **Annuities Require Careful Tax Planning**

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One popular benefit of a fixed annuity is that you can let the interest compound in the account each year without paying income taxes. This allows your money to possibly grow faster as compared to fully taxable investments that pay similar, before-tax returns. When you start making withdrawals, the percentage of income that is taxable depends on how you structure the distributions. Your beneficiaries, however, may not have that flexibility, and could face a big tax bill on the inheritance.

Assuming your annuity is not held in a tax-qualified account, such as an IRA, your heirs will have to pay income tax on the built-up earnings when you die. So for instance, suppose that you had put \$250,000 into a fixed annuity a number of years ago, and now it is worth \$450,000. If you died today, your beneficiaries would receive the \$450,000, and would have to pay as much \$70,000 in federal income taxes on the accumulated profit. (Maximum federal income tax rates are currently 35%). Please note a 10% federal tax penalty may apply to withdrawals taken prior to age 59½.

To help your heirs keep the money you earned, you may want to consider purchasing a life insurance policy for the amount of the estimated tax bill. You could pay the premiums yourself, ask your beneficiaries to buy the policy to protect their future interests. Or you could annuitize your annuity. Annuitizing your annuity can give you a steady income that you cannot outlive. Part of the income will be a tax-free return of your original investment. The balance will be taxed as ordinary income. However, the \$450,000 will no longer be available to go to your beneficiaries. To replace that money, you could use the regular income that you will receive from the annuity to help pay life insurance premiums on a \$450,000 policy. After you die, your loved ones will receive the entire \$450,000, free of federal income taxes.

Not everyone can qualify for a life insurance policy. Depending on the payout from the annuity, your health and other factors, the payout from the annuity may not cover the full premium payment on the life insurance.