Five Facts about Commercial Annuities

Commercial annuities are contracts with insurance companies that promise to provide an income stream. Fixed annuities base payouts on a predetermined rate of return. Variable annuities base payouts on the success of investments made with the premiums, although there may be a fixed minimum payout. Annuity payments may be guaranteed for life, which ensures a lifetime of retirement income, or made over a fixed term, such as 10 years. From a tax perspective, there are some positives and negatives about commercial annuities to consider.

Income is deferred until you annuitize - The chief tax advantage to commercial annuities is tax deferral. There is no current taxable income from the annual earnings from the contract. Income is deferred until you take withdrawals. Then, a portion of each payment is a return of your investment, which is not taxed, and earnings, which are taxed.

Distributions prior to age 59$^1/_2$ are penalized - There is a 10% early distribution penalty unless payments at this age are made because of disability or other permissible reasons. For example, there is no penalty if the payment is from an annuity contract under a qualified personal injury settlement or from an immediate annuity, which is a single-premium annuity where the starting date is no more than 1 year from the date of purchase.

Loans are treated as cash withdrawals - If you borrow against the contract, you are taxed in the same way as if you'd taken a distribution. This distribution is taxable to the extent that the cash value of the contract exceeds your investment in the contract (the premiums you paid for the annuity).

Annuity contracts can be exchanged tax free - You can swap one annuity contract for another without any current taxable income as long as you are the annuitant of the old and new policies.

However, you cannot exchange on a tax-free basis an annuity contract for a life insurance contract or endowment policy. Also, if there is a loan outstanding on the old policy, the exchange can trigger taxable income.

Heirs are taxed on annuity distributions - Some annuities cannot be passed on because payments cease at the owner's death. However, other annuities have guaranteed payouts. What that means is that amounts that have not been paid to the owner will be paid to named beneficiaries. While an inheritance of any type of property in any amount is tax free, annuity payments made to beneficiaries are taxable in the same way as they would have been had they been made to the contract owner before death.

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