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Six commonly asked questions about annuities during tax season

March is a great time of year to talk to your clients about the benefits of annuities

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Clients often have questions around the taxable status of an annuity before they purchase. (Photo: iStock)

It's that time of year again: tax season.

March is a great time of year to talk to your clients about the benefits of annuities. This is because they have been receiving 1099 forms in the mail over the last month — and seeing just how much tax they are paying on the interest in their investments. Many people are very interested in learning how they can reduce their

While your job description may not include "tax advisor," clients often have numerous questions around the taxable status of an annuity before they purchase. Here are some commonly asked questions you may get this year, along with answers you can use to help clients understand the tax benefits of purchasing an annuity.

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No. 6: When is an annuity taxed?

An annuity isn't taxed until a client makes a withdrawal or starts taking regular distributions. As a result, for a client who is simply letting his or her money grow with interest, the money continues working for the client instead of for Uncle Sam.

No. 5: What is the advantage of owning an annuity over another type of savings vehicle?

An annuity can make a client's money work harder for them. That's because he or she can earn interest on the principal, interest on the interest, and interest on the tax savings. This triple-compounding process is great because the interest from an annuity is not subject to current income tax until it is withdrawn — meaning 100 percent of your client's interest can continue to compound instead of being used toward taxes.

No. 4: Can I move money from my retirement plan to an annuity without getting taxed?

Yes. If your client has money in a corporate retirement plan — such as a 401(k), 403(b) or 457 plan — or in an existing IRA, those funds can be transferred into an annuity tax-free. This can be done without any tax implications, as long as the annuity is designated on the application as an IRA.

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What's more, as an annuity earns interest, that interest can stay in the annuity tax-free. However, as with all IRAs — and as with all corporate retirement plans for that matter — when your client ultimately takes withdrawals, the withdrawals will be taxed as ordinary income.

An annuity can make a client's money work harder for them. (Photo: iStock)

No. 3: What if I have money in a Roth IRA or Roth retirement plan?
Roth funds can also be transferred into an annuity tax-free. Simply designate the annuity on the application as a Roth IRA.

As the annuity earns interest, that interest can stay in the annuity tax-free. And, with a Roth IRA annuity, there is an additional benefit. As long as your client keeps the money in the annuity for at least five years before taking a withdrawal, and doesn't take any withdrawals before age 59½, the withdrawals and interest credits can be completely income-tax-free.

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No. 2: What about moving money from my savings to an annuity?
General savings is called nonqualified money, and since general savings has typically already been taxed, this transfer can be done tax-free as well. Rolling a client's nonqualified savings into an annuity will also create tax advantages, as interest will be credited to the annuity and not taxed until a client withdraws it.

If your client is moving nonqualified investments such as stocks or mutual funds into an annuity, then the transaction would be taxable to the extent that your client understand is that any withdrawal amount taken prior to age 59½ is subject to a tax penalty. This penalty is assessed on a client's federal income tax return — not by the company that issued the annuity. As the withdrawal amount is subject to a 10 percent penalty, it's important to counsel a client that if he or she does invest in an annuity before age 59½, that they don't plan on taking money out until they reach that age.

The tax treatment of an annuity is one of many attractive reasons for clients to purchase this type of product. By helping clients understand tax implications now, you can help save them from feeling the pain next tax season.

Chris Conklin is vice president of individual annuities at The Standard, where he has full P&L responsibility for the individual annuities line of business. Besides being a Fellow of the Society of Actuaries, Chris is a licensed agent, has sold insurance and annuities, and co-owned a national marketing organization.

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