A TAX DEFERRED IS A TAX SAVED

A tax deferred is a tax saved. Tax deferral works because the taxpayer earns a return on the amount that he or she otherwise would have sent to Uncle Sam in taxes. That, of course, leads us to a brief discussion of the tax treatment of annuity contracts. For purposes of this article, we are restricting our comments to some of the rules governing regular, non-qualified annuities. Annuity contracts that are part of IRAs, 403(b) plans, 401(k) plans and other qualified retirement plans are covered by different rules.

The taxation of distributions from annuity contracts depends on two factors: first, whether the withdrawals were made in the form of an annuity and, second, whether they were made before or after the year you turned 59-1/2. If payments from the contract are received in the form of a fixed annuity payment, the taxpayer may exclude a portion of each payment that is considered to represent his or her original investment. The amount excluded is computed by first calculating the "exclusion ratio." The exclusion ratio equals the original investment divided by the expected return. The expected return is calculated by multiplying the annual payment by IRS approved life expectancy tables (assuming a life annuity) or the period certain of the annuity.

Here's an example, Arnold invests $50,000 in a deferred annuity contract. Several years later when the contract is worth $225,000, Arnold (then age 67) elects a single life annuity. The company promises to pay him $19,633 per year. Using the IRS single-life unisex tables, Arnold's life expectancy is 18.4 years. That gives him an expected return of $361,245. That gives him an exclusion ratio of 14% ($50,000/$361,245). Arnold will exclude about $2,749 (19,633 x 14%) from each year's payment until he recovers all his original investment. Thereafter, 100% of the payment is taxable.

Withdrawals from annuity contracts issued after August 13, 1982 that are not made in the form of an annuity are considered to be ordinary income first, to the extent of any earnings inside the contract, and then a return of capital. Congress has imposed a 10% penalty tax (in addition to any contractual penalties) for withdrawals made prior to turning 59-1/2. The tax is based on the amount of the withdrawal that is included in taxable income. Like most tax rules, there are some exceptions to the 10% penalty.

The penalty does not apply to withdrawals included in taxable income: 1) made on account of death or disability, 2) attributable to premiums paid before Aug 14, 1982, 3) annuity payments that begin within 1 year of the date the contract was purchased and 4) that are part of a series of substantially equal payments over the life of the taxpayer or the taxpayer and a designated beneficiary. There are other exceptions that relate to annuities inside retirement plans and as used in structured settlements of litigation.

Of course, this brief article is no substitute for a careful consideration of all of the advantages and disadvantages of this matter in light of your unique personal circumstances. Before implementing any significant tax or financial planning strategy, contact your financial planner, attorney or tax advisor as appropriate.

Arthur Rottenstein is a Branch Manager for Raymond James Financial Services, Inc. (Member FINRA/SIPC) in Boca Raton, FL. He may be reached at (561) 391-6961 or at Arthur.Rottenstein@raymondjames.com.