and the annuitant to facilitate the contract.

Oct. 20, 2023

People preparing for retirement have mandatory Social Security meant for post-retirement costs. However, Social Security is barely enough to sustain one's cost of living in today's economy. Private pensions like 401(k) and annuities help as additional retirement preparation plans, but in reality, not many people know of

either through a financial advisor, an insurance agent, or an insurance website AI chatbots, for a regular income stream in the future through a single payment now or fixed payments over a fixed period. The income stream from annuities will be paid to your clients on a lump-sum basis or a fixed monthly amount in the future.

People who avail of annuities are called annuitants, and these annuitants take advantage of annuities for guaranteed payment streams—mostly beneficial for retirees, day-to-day sustenance, or post-retirement business financing.

How do annuities work?

As financial advisors, you will act as a middle ground between the insurance company and the annuitant to facilitate the contract. There are two principal phases of annuities, such as:

Accumulation phase

The accumulation phase is when the annuitant makes payments and funds his annuity over a specified time. At this point, the annuitant builds up their wealth and increases the value of their investment in preparation for the distribution or annuitization phase.

At this point, your client's funds grow on a tax-deferred basis—meaning they are not required to pay taxes on the money that grows on their annuities until the annuitization phase (generally, as for qualified annuities).

It is also important to remember that only deferred annuities have accumulation periods, not immediate ones—because immediate annuities are paid on a lump sum basis by your clients for a regular payout period in the future.

Annuitization phase

Types of annuities based on tax treatment

Based on taxation, there are two kinds of annuities: qualified and non-qualified.

Qualified annuities

In terms of taxation, qualified annuities are taxed during their payout period. Because they are funded with pre-tax dollars, payment of taxes will take effect once the annuitants start to receive their money as part of their income taxes, with the IRS using the 1099-R form to declare income from private retirement savings, annuities, or pensions.

Non-qualified annuities

On the other hand, non-qualified annuities are funded with pre-tax dollars, meaning that tax is already paid to the IRS before the principal amount is invested. This does not, however, mean that the entire payout you will receive in the future will be tax-free.

The exclusion ratio will determine how much an annuitant's annuity income is taxable (typically the interest earnings on the investment).

Pros and cons of annuities

Unlimited funding

Unlike IRA or 401(k), which have IRS-mandated annual contribution limits, annuities don't have these limits. This means that you can indefinitely avail and fund your annuities as much as you like to grow your investment or get larger payouts in the future.

Risk and returns

If you opt for safer annuity options where annuity value is less likely to be affected by market losses, you can choose to avail of fixed annuities instead.

Early withdrawal penalties

One drawback of annuities is that they are locked up for a specific period—as short as two years to as long as more than ten years, also called the *surrender period*—-and during that period, annuitants are discouraged from withdrawing their investments if they don't want to incur early withdrawal penalties.

There are typically two types of penalties to be incurred by annuitants if they decide to withdraw their funds early. These are:

1. **Annuity surrender charges.** These are charges made by the insurance company against the annuitant, usually a contingent deferred sales charge (CDSC) at 10 percent (or less) of the contract value, of which the percentage may decrease after each passing year of the contract.
2. **Tax penalties.** Aside from charges made by the insurance company, early withdrawal may incur another 10 percent penalty tax with the IRS.

Death benefits

Like a regular life insurance contract, an annuity allows annuitants to assign annuity payouts to a beneficiary even after death, either in a lump sum payment or a regular income payout.

These death benefits are usually included in their annuity contract and may be enhanced subject to additional costs.

No change in taxation, even for inherited annuity

The catch with inherited annuity income on the part of the annuitant's beneficiary is

Shawn Plummer is CEO at The Annuity Expert and has been a licensed financial professional focusing on annuities and insurance for more than a decade. His former role was training financial advisers, including for a Fortune Global 500 insurance company. He's been featured in Time magazine, Yahoo! Finance, Entrepreneur and Bloomberg.

Financial Planning