How Are Annuities Taxed?

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Annuities offer tax-deferred growth on the funds held within them, just like Traditional IRAs and 401(k)s. These insurance contracts allow you to hold off on paying taxes until you start receiving payments. When payments begin, you'll be required to pay income tax on the money you receive. However, the amount of taxes you owe will depend on how the account was funded.

How Are Qualified Annuities Taxed?

Qualified annuities are funded with pre-tax dollars and grow tax-deferred. Every dollar will be subject to federal and state taxes at the ordinary income rates upon distribution.

Annuities are considered contracts rather than investments, which is why **they are always taxed at ordinary income rates**. While some investments held for a year or longer qualify for a more favorable tax treatment(long-term capital gain rates), any money you receive from an annuity will be treated as ordinary income and will be taxed accordingly.

How Are Non-Qualified Annuities Taxed?

Non-qualified annuities are funded with after-tax dollars, often with money from a brokerage, checking, or savings account. Contributions to non-qualified annuities are not taxed again upon distribution, but the growth within the account will be. The investment growth will be subject to federal and state tax at ordinary income rates.

Determining the taxable portion of your distributions for non-qualified annuities can be tricky because there are two distinct ways to access your money.

Annuitization of Non-Qualified Annuities

Annuitization occurs when you convert the value of the contract into a series of guaranteed income payments. Each annuitized payment is a combination of your own contributions and investment gains.

To determine how much of your payment will be taxable, annuity companies use a calculation known as the exclusion ratio. This formula includes three components: your contributions, gains within the account, and your life expectancy. If you want to know how much of your payment will be taxable, you should get in touch with your insurance company. They will be able to provide you with this information.

Note: If you live longer than the annuity company anticipates, the entire payment will be fully taxable at ordinary income rates.

Withdrawals from Non-Qualified Annuities

Those who are simply making a one-time withdrawal from their annuity will be taxed under the Last-In-First-Out (LIFO) rule. This means that the earnings portion, which is the taxable part, will be used for withdrawals before you can access your tax-free contributions.

To illustrate, imagine you funded a non-qualified annuity with $100,000 and it has grown to $150,000 when you start to withdraw from the account. You will need to withdraw the entire $50,000 of taxable growth before you can withdraw the $100,000 of your initial contribution.

Other Considerations

While most annuities grow tax-deferred and will be taxable upon distribution, there is one exception. If you funded your annuity with Roth dollars (either from a Roth IRA or Roth 401(k)) then you will **have tax-free growth and withdrawals.**

The Bottom Line

Navigating the taxation of annuities can be complex. While insurance companies emphasize the tax advantages of annuities, there is an important caveat: annuities are always subject to ordinary

income rates rather than long-term capital gains rates. Understanding how annuities are taxed empowers you to make informed decisions and effectively plan for your financial future.