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# Multiple Uses of Annuities

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## Introduction

Annuities can be powerful financial planning tools. Most often used as an insurance product, an annuity can also be used as an investment vehicle, as a way to turn lump-sum income into a stream of payments, and as a way to make a charitable gift while providing for your own financial security.

For this discussion, it's assumed that investors understand how an annuity works, but a quick review of some pertinent points may be helpful. Essentially, annuities work like this:

- You make premium payments with after-tax dollars (Note: we're only discussing nonqualified annuities here)
- Your money may be invested in a variety of investment vehicles (i.e., subaccounts) that you choose
- You can switch money among various subaccounts without triggering taxes
- Earnings grow tax-deferred until they are withdrawn (but if funds are withdrawn before age 59½, you may also incur a 10 percent federal penalty tax)
- Earnings are taxed as ordinary income, not capital gains
- You can make withdrawals from the annuity, or you can receive regular periodic payments for life (i.e., annuitize)
- You can contribute as much as you want until you annuitize
- Fees and charges are typically quite high

## Retirement funding

Individuals most often use annuities as a supplement to a retirement savings plan because they can guarantee a fixed income stream for life. However, because contributions to annuities are made with after-tax dollars and because annuities tend to charge high fees that reduce earnings, they are typically used only after an individual has already contributed the most he or she can to other tax-deductible and tax-deferred retirement plans (e.g., employer-sponsored retirement plans , and individual retirement accounts (IRAs) ).

But if you're looking for an additional tax-deferred retirement savings opportunity, an annuity may be the answer. Why? Besides offering insurance that you won't outlive your savings and tax deferral on earnings, annuities allow unlimited contributions and do not have minimum distribution requirements at age 70½ (unlike some employer-sponsored retirement plans and traditional IRAs).

***Caution:*** *Guarantees are subject to the claims-paying ability of the annuity issuer.*

### *Emergency funding*

Even some individuals who anticipate that they will have enough income during retirement to pay for living expenses use annuities to provide for extra income in old age in the event of some emergency such as a catastrophic or prolonged illness or the need for long-term care or nursing home care. Even if the emergency funds are not used, the owner can pass the annuity along as part of his or her estate to children or grandchildren.

## Turning lump-sum savings into a stream of income payments over time

Individuals can use annuities as a way to receive income from life insurance proceeds, lottery winnings, the sale of business property, an inheritance, a legal award or settlement, or other sources in the form of periodic payments instead of as a lump sum. These individuals may prefer an annuity because they don't feel able to manage their money well enough on their own and they want the certainty of an income that will remain constant. Another reason to annuitize a lump sum--taxes. A lump sum is taxed all at once, while annuity payments are taxed as they are received.

## Education savings

As is the case with retirement planning (see above), there are many education savings vehicles that offer tax benefits that are more advantageous than those offered by an annuity.

For example, though contributions are made with after-tax dollars (the same as with an annuity), a Coverdell Education Savings Account (Coverdell ESA) or a Section 529 plan allows you to make tax-free withdrawals (and penalty tax-free even if withdrawals are made before age 59½) as long as the funds are used for qualified education expenses.

However, contributions to a Coverdell ESA are limited to $2,000 per year (less if your income is greater than a certain amount). Contribution limits to Section 529 plans are much higher--typically a total of up to $250,000.

Since annuities offer tax-deferred earnings and unlimited contributions, certain individuals may want to use them to complement a family's other education savings vehicles. However, because withdrawals from annuities made before age 59½ may be subject to a 10 percent federal tax penalty, annuities may make sense only if you're going to be older than 59½ when your child or grandchild enters college.

**Caution:** *If withdrawals from a Coverdell ESA or a Section 529 plan are not used to pay for qualified education expenses, the earnings will be subject to tax and a 10 percent federal penalty tax may also apply.*

# Charitable gifting

A charitable gift annuity (CGA) allows an individual to provide for his or her own financial security while making a gift to a charity and enjoy the accompanying tax benefits. A CGA is part gift and part annuity contract with the charity. You make an irrevocable gift of cash, marketable securities, or other property to the charity. In return, you (and/or a second beneficiary) receive a fixed income for life (not for a period of years) in the form of annually, semi-annually, or quarterly payments. You get an immediate income tax deduction (the size of which is determined by IRS actuarial tables). The annuity payments you receive are tax-exempt to the extent they represent return of principal (any portion that represents appreciation is taxable at capital gains tax rates; any portion that represents interest earnings is taxable at ordinary income tax rates). The property will not be included in your estate at your death, avoiding estate taxes.

**Caution:** *A CGA is not a trust. With a CGA, the charity guarantees the annuity (subject to the charity's claims-paying ability). With a trust, annuity payments are made from trust assets. For more information, see our separate topic discusssion,* Charitable Remainder Annuity Trust (CRAT) *.*

**IMPORTANT DISCLOSURES** This presentation is not intended to and does not provide investment, tax, legal, or retirement advice or recommendations. The information presented here is not specific to any individual's personal circumstances. To the extent that this material concerns tax matters, it is not intended or written to be used, and cannot be used, by a taxpayer for the purpose of avoiding penalties that may be imposed by law. Each taxpayer should seek independent advice from a tax professional based on his or her individual circumstances. These materials are provided for general information and educational purposes based upon publicly available information from sources believed to be reliable — we cannot assure the accuracy or completeness of these materials. The information in these materials may change at any time and without notice.


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