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When to Help Your Clients Say NO to Tax Deferral

The truths and fallacies of annuities revealed.

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Your clients could be making huge mistakes by setting up certain tax deferred accounts.

In most cases, it *does* make sense for them to maximize contributions to IRA, 401(k) and 403(b) accounts. In fact, many of your clients are amassing the bulk of their financial assets in these pretax accounts. Depending on your clients' tax brackets — now and in the future — it's easy for you their CPA, to determine whether it makes sense to make these deposits. But the picture becomes trickier when dealing with annuities.

When to Purchase Annuities

Are annuities always bad investments? No. But they are often sold to people for the wrong reasons. Let's examine the pros and cons of annuities as investments.

As you know, an annuity is a deposit with an insurance company. Unlike bank deposits, the distinguishing feature of an annuity is that any interest earned grows tax-deferred as long as it is not withdrawn from the insurance company. So if your clients are in a high tax bracket now, and will probably be in a lower tax bracket in the future, an annuity could work well. Also, the longer the interest grows tax-deferred, the better.

Let's take a look an example to illustrate this point.

Steve is 50 years old and currently in the 35 percent federal income tax bracket. When he retires in 10 years, his income will be dramatically reduced, so he'll be in a lower tax bracket (all things being the same). For Steve, buying an annuity today might be a great alternative. If he deposits \$100,000 and locks up 5.5 percent for 15 years, his investment will grow to \$223,000. If he puts the money in a traditional, i.e. taxable, certificate of deposit (CD) at the same rate (but pays tax on the interest), his money will grow to only \$169,000.

By using the tax-stingy annuity, he'll have significantly more income 15 years down the road. In fact, if he withdraws income only, his net income will be \$10,500 annually (assuming he is in the 15 percent tax bracket when he retires).

Had he purchased that taxable CD instead, his annual after-tax income would be only \$7,900. So, for Steve, the benefit of having purchased the annuity at 50 years old is a 32 percent increase in annual income. Not too shabby.

In fact, Steve's case is the best example of when annuities make sense for your clients.. When do they not make sense? In almost every other case.

When *Not* to Purchase Annuities

The most glaring example of when your clients should avoid purchasing annuities is when it comes to retirement accounts. As you know, any investment made in a retirement account grows tax-deferred. Clients can purchase government bonds, CDs, stocks, mutual funds — just about anything — and whatever clients invest in will grow tax-deferred. That being the case, there is no reason in the world to buy an annuity within a retirement account. The most distinguishing benefit of an annuity (tax-deferred growth) is lost in a retirement account, since any investment within a retirement account grows tax-deferred. In fact, buying an annuity within a retirement account is like paying Yo Yo Ma to turn on the radio. Tell your clients to save their money.

Using Annuities to Create Current Income

What about using an annuity to create current income? Not much sense in that, either. As soon as the interest is withdrawn from the annuity, it will be taxed. Your clients are better off buying government bonds or CDs if they want stable principal and monthly income.

The only exception to this is with an immediate annuity. An immediate annuity is an investment that enables investors to give an insurance company a one-time deposit and the insurance company promises to pay them an income stream for some period of time, usually for a lifetime. This type of investment may make sense for some people. The payments are fixed and never change, but the older the clients are when they make this investment, the better. The insurance company figures that the older someone is, the less time they have to collect. As a result, older investors usually make out better with these deals. But keep in mind that once your clients buy an immediate annuity, they can never have random access to their capital. All they have is an income stream. For most people, this is the deal killer.

Other Annuity Issues

Perhaps the greatest problem with annuities is that 90 percent of them are held by people until they die. It's like that commercial for roach poison. Your dollars check in ... but they never check out! Why is that? Well, your clients get sucked into buying an annuity under the impression that they can avoid paying taxes today (true) and withdraw the interest someday in the future when their tax rate is lower (rarely happens). As investors' annuities build, it becomes even more expensive (tax-wise) to withdraw the money. Most people just leave the money in the annuity until they die rather than pay the tax, so they never get any benefit from the annuity.

To make matters worse, when they die, the beneficiaries usually have to withdraw the annuity interest first, over one to five years. The beneficiaries will pay huge income taxes on those withdrawals.

And let's not forget that every dime that comes out of that annuity (excluding the principal deposit) is taxed at income rates. Better alternatives are available whereby the growth in value would be taxed at lower capital-gains rates.

Jennifer's mother bought an annuity 10 years ago. She invested \$50,000, and when she died last year, the account was worth over \$150,000. The insurance company is forcing Jennifer, who is in a much higher tax bracket than her mother, to withdraw the entire amount within 12 months of her mother's death. That means Jennifer will have an extra \$100,000 in taxable income to report this year. Not a happy outcome considering the alternatives.

What Makes an Annuity a Good Deal?

In summary, when is an annuity a good deal for your clients?

1. When they are in a high tax bracket currently.
2. They have at least 10 years before they need the income.

3. Your clients will be in a lower tax bracket when they retire.
4. They will use the accumulated values in the annuity to create monthly income in the future.

In most other cases, the annuity becomes a default tool to pass assets to beneficiaries — and an inefficient tool at that. If the goal is to pass estate assets to beneficiaries, better tools are assets subject to capital gains treatment like real estate or equities or investments that can escape income and estate tax altogether, such as life insurance. If the goal is to maximize investments now in order to create greater retirement income, the annuity is usually a bad option.

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Neal Frankle is the author of *Why Smart People Lose a Fortune: 5 Steps to Restoring Your Wealth and Sanity*. He helps affluent clients establish and implement a safety-net strategy to protect their wealth. He also helps other professionals, such as CPAs, to do the same thing for their clients.

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