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Are Annuities Worth the Investment?

Key annuity myths debunked.

by *Neal Frankle, CFP*

Have you ever seen someone attacked by a shark on dry land? I have.

Bob and Martha got chewed up pretty badly by a shark disguised as an annuity salesperson a few years back. "Jaws," as he is disaffectionately known in the investment industry, took Bob's \$750,000 IRA and invested it into a fixed annuity. This was a great outcome for Jaws — he made a \$45,000 commission on it, but it was a terrible move for Bob and Martha.



Neal Frankle

Are IRAs 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 a CPA, you probably know that an annuity is a deposit with an insurance company. The distinguishing feature of an annuity, of course, is that any interest earned grows tax-deferred as long as it is not withdrawn from the insurance company. So if your client is in a high tax bracket now, and will probably be in a lower tax bracket some time in the future, an annuity could work well. Also, the longer the interest grows tax-deferred, the better.

Example: 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 CD and pays tax on the interest, his money will grow only to \$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 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 was a 32 percent increase in annual income. Not too shabby.

In fact, this is the best example of when it might make sense to purchase an annuity. When does it fail to make sense? In almost every other case.

Myth #1: Purchasing Annuities in Retirement Accounts

As you know, any investment you or your clients make in retirement accounts grow tax-deferred. You and your clients can purchase government bonds, CDs, stocks, mutual funds — just about anything you want in a retirement account — and whatever you invest in will grow tax-deferred. There is no reason in the world to buy an annuity within a retirement account. The most important distinguishing benefit of an annuity (tax-deferred growth) is lost in a retirement account since any investment within a retirement account grows tax deferred anyway. In fact, buying an annuity within a retirement account is like paying Yo Yo Ma to turn on your radio. Save your money.

Myth #2: Using Annuities 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 will be better off buying government bonds or CDs if they want a stable principle and monthly income.

Immediate annuities are the only exception to this scenario. An immediately annuity is an investment in which your client gives an insurance company a one-time deposit and the insurance company promises to pay your client an income stream for some period of time, usually for a lifetime. This type of investment may make sense for some clients. The payments are fixed and never change, but the older your 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 clients 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.

Perhaps the greatest problem with annuities is that 90 percent of them are held by investors until they die. It's like that commercial for roach poison. Your dollars check in ... but they never check out! Why is that? Well, clients get sucked into buying annuities 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 grow and grow, it becomes more and more expensive (taxes) 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.

Example: 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 was, 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.

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

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

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, do the same for their clients. To receive a free report on how to find the best funds, sending him an [e-mail](#).

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