

How Are Annuities Taxed?

One of the most attractive features of an annuity is its tax-deferred status. Generally, you won’t pay any income tax on the interest or earnings until you start taking withdrawals in retirement (age 59½ or later).

Qualified and nonqualified annuities are taxed differently. Qualified annuities (such as annuities in an employer-sponsored retirement plan or an IRA) are typically purchased with pre-tax money, so withdrawals are fully taxed as ordinary income. It’s important to understand that purchasing an annuity in an IRA or an employer plan provides no additional tax benefits than those available through the original tax-deferred retirement plan.

Annuities purchased with after-tax money are taxable upon withdrawal, but only the earnings are taxed. Nonqualified annuities bought after August 13, 1982, are taxed on a Last In, First Out (LIFO) basis. This means that as you take withdrawals, the accrued interest will be the first money taken out and taxed as ordinary income. After the interest has been paid, the initial investment amount will then be distributed without any further taxes.

Most annuities have surrender charges that are assessed during the early years of the contract if the contract owner surrenders the annuity. In addition, if the contract is surrendered before age 59½, you may be subject to a 10% federal income tax penalty.

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