

What is an annuity? – Tax-qualified or not? Deferred or immediate?

Part 4 of 9

What makes an annuity “qualified” or “nonqualified”?

Qualified annuities are funded with pretax dollars — that means income tax has not been withheld from the money in a qualified annuity. Generally, qualified accounts are funded by contributions to your employer’s workplace retirement plan [such as a 401(k), 403(b) or 457(b) plan] or to an IRA. You may contribute up to a maximum amount specified under the Internal Revenue Code each year. In 2010, that amount is \$16,500. Internal Revenue Code also specifies that you begin withdrawing money when you reach age 70½ or, in the case of employer-sponsored plans, when you retire if that is later.

Nonqualified annuities are purchased with after-tax dollars — that means income tax withholding has already taken its bite. Nonqualified annuities don’t have the contribution limits you find with qualified annuities. In fact, you can contribute up to \$1 million annually to a nonqualified annuity in some cases. Federal law doesn’t specify when you must begin receiving income from a nonqualified annuity.

Deferred or immediate? Depends on your financial objective.

Deferred annuities are built around two phases: accumulation (the time when you contribute money) and payout (the time when you start receiving income). During the years you’re setting money aside, tax deferral can help your savings accumulate faster since money that would have gone toward taxes can stay in your account and grow through tax-deferred compounding. Of course, income taxes are payable on withdrawal. And if you withdraw money before you turn age 59½, you may incur federal restrictions (for qualified contracts) and a 10% federal early withdrawal penalty in addition to the income taxes.

With **immediate annuities**, you can convert assets to an income stream that starts shortly after the insurance company receives your payment (premium). For example, you can purchase an immediate annuity with a single payment and start receiving income usually within 30 days and no later than 12 months.

Read about more annuity types in Part 2 and Part 3.

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