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# How The Smart Money Uses Tax-Deferred Annuities

Tax deferral!  
Guaranteed  
minimum  
return!

Those two come-ons sell a lot of variable annuities. These are investment accounts that look suspiciously similar to plain old mutual funds but, dressed up as a form of life insurance, get certain tax benefits.



Image by Loren Sztajer via Flickr

People worried about taxes and market crashes are pouring money in, at the rate of \$140 billion a year. Alas, most of this is dumb money. Dumb buyers pay fees high enough to wipe out any conceivable benefit from deferring taxes or sidestepping market declines.

And yet, tax-deferred annuities can be a winning investment if you know what you're doing and keep your costs down. You just have to know where to find the low-cost products.

Consider annuities if you (a) are in a high tax bracket (b) have exhausted other forms of tax-favored retirement savings, like 401(k)s and IRAs and (c) want to own more bonds, especially corporate bonds.

You put in a lump sum—say, \$100,000—and let it compound tax free for a long time, preferably at least a decade. When you pull it out, profits are

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taxable as ordinary income. If you make withdrawals before turning 59-1/2 you will probably also owe a tax penalty.

Return guarantees are a frequent feature but are not integral to the operation of the tax game. The classic guarantee is a return of principal to your heirs if the portfolio goes down and you die before cashing in the annuity.

You put in \$100,000, the portfolio dips to \$93,000 and just then you get run over by a train. Your heirs get back the original \$100,000. That's like having \$7,000 of life insurance on the side.

It's kind of hard to get any enjoyment out of this particular rider on your annuity policy. Maybe you'd want it if you have a knack for finding investments that go down, and also plan on having your car stall on a grade crossing soon after.

At one time it was believed that this roundabout sliver of life insurance was necessary to get the tax deferral. Modern legal technology has made this guarantee unnecessary. You can, and should, select a stripped-down annuity that has not a whiff of insurance protection.

Despite the hazards, you can do well with a tax-deferred annuity. Follow these eight rules.

*Buy from a no-load fund company.* Outfits like Fidelity, T. Rowe Price and Vanguard don't have to pay commissions to sellers, so their annual fees are lower and they don't hit you up for a "surrender charge" if you take your money elsewhere a few years later.

*Keep expenses low.* Compare the annuity account you like to a low-cost fund that invests in the same sort of securities. Don't pay more than half a percentage point a year extra to get the annuity.

*Don't buy stocks.* Put bonds in your annuity. Their high current income makes the deferral feature valuable.

With stocks you don't get much deferral that you couldn't have had merely by buying an index fund in your taxable account and standing pat. Worse, an annuity will convert stock appreciation taxed at favorable capital gain rates into ordinary income taxed at high rates.

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If you are tempted to get equity exposure through a deferred annuity, resist. Instead, buy a stock index fund like SPDR (SPY) or the Schwab Total Stock Market Index Fund (SCHB).

*Skip the guarantees.* Vendors of high-cost annuities concoct complex products that have you getting protection from market declines in return for giving up some of the gain in up markets. These are always bad deals. Of course, there's no way for you to know that unless you have two actuaries and a computer programmer working for you.

There's a better way to protect yourself from the next market crash: Don't put so much money in stocks. If you can't sleep at night, switch some of your retirement savings into medium-term bonds.

*Put annuities last on your shopping list.* First, fill up your 401(k) or self-employed retirement plan to the max. Next, see what you can do with IRAs, even of the nondeductible variety.

Third, put some money in municipal bonds. Not too much, because California and New York might stiff creditors (see this take on [Deadweight Ratios](#)). But some. Tax-exempt bonds are more powerful than annuities at tax time. They give you an exemption rather than a deferral.

Then, and only then, should you think about buying annuities.

*Stay put.* It takes a while for the cumulative benefit from deferral to overcome the cost drag of a deferred annuity. For a high-bracket investor holding corporate bonds, I figure, it takes more than a decade. And that's with a low-cost annuity.

*Think about liquidity.* If you need the money back before you turn 59-1/2, you'll have that tax penalty: a 10% surcharge, on top of regular income taxes, on any earnings.

A separate liquidity matter has to do with back-end charges levied by the vendor. You avoid this problem by not buying products with these charges.

*Use for the intended purpose.* The original idea behind deferred annuities was to have your money growing untouched for a number of years (the "accumulation phase") and then being converted into a lifetime monthly annuity ("annuitization phase"). It's not a bad idea.

Suppose you put in \$100,000 at age 50, investing the money in junk bonds. It grows to \$200,000 when you're 65. You could just cash in the policy, paying tax on \$100,000 of ordinary income. Better: use the \$200,000 to buy a so-called immediate annuity paying a fixed monthly sum for as long as you live. A 65-year-old male would get \$1,200 a month, or thereabouts, from this lump sum.

The exchange from deferred to immediate continues your tax deferral, if you do it right. (It's called a Section 1035 exchange.) Some of that money you put away when you were 50 is coming out when you're 80, having benefitted from 30 years of tax-deferred compounding.

Remember, though, that an annuity only delays the reckoning with the tax collector. In our example you'd be collecting \$14,400 a year but paying tax on \$9,400 because you get a tax deduction of \$5,000 a year. Over 20 years you recover your original purchase price with this deduction.

The recovery period is spelled out in IRS Publication 939. After it ends your paychecks are fully taxable, but what the hell. You've won the bet with the life insurance company.

If the train comes before you have recovered your cost, the unused balance can be claimed by your heirs as a deduction on your final return.

Shop around before making your 1035 switchover. There may be a guaranteed annuitization formula written into your deferred annuity contract, but you can safely ignore it. You'll get a better deal in the open market, maybe even from the same life insurance company that held your annuity during the accumulation phase.

So why did the original policy even carry an annuitizing formula? It was a charade that turned your plain old mutual fund into "life insurance" worthy of tax deferral.

And why does the tax code treat insurance with such deference? Recall that much of the money going into annuities is from not very bright investors paying high fees (3% a year, in some cases). The insurance industry recycles a portion of this money, investing in lobbyists who in turn invest in congressmen.

Be thankful for all this. If it weren't for dumb

investors, how would the rest of us make money?

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