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QUALIFIED VS. NON-QUALIFIED ANNUITIES

By: John Egan - September 6, 2022

It's not enough to ask whether you should buy an annuity, or even which one you should choose. Deciding where to purchase an annuity has critical implications for taxes.

Not all annuity purchases are treated equally by the IRS. There are two tax categories to consider: qualified annuities and non-qualified annuities. Which you get determines when and how much you pay Uncle Sam.

Follow along to learn more about what separates a qualified vs non-qualified annuities.

What Is An Annuity?

Think of an annuity as the opposite of life insurance: It's a financial product that can help ensure you don't run out of money before you die.

An annuity is an insurance contract that promises payouts to you that start right away or that happen down the road. You can buy an annuity by making a single payment or a series of payments, called premiums.

Are annuities a good investment? An annuity can provide a guaranteed stream of income after you retire. By annuitizing a portion of your nest egg—enough to cover basic monthly expenses, for instance—you can invest the rest of your portfolio in more volatile but ultimately higher yielding securities, such as stocks.

Unfortunately, many retirees are uninterested in annuities even if they would personally benefit from them, a phenomenon known as the "annuity puzzle." Folks aren't thrilled at the prospect of handing over a big chunk of change all at once, or even over time, for a series of payments; what if I die before I recoup my principle?

Moreover, many people are turned off by annuities themselves. There are a variety of different types—fixed, variable, indexed—each with their own rules and conditions. You can buy them with pre-tax or after-tax income (more on this below), and you can have the annuity start upon retirement or deferred until you're 85.

Making a decision with so many different considerations is challenging, which is why you should consult a fee-only financial advisor before doing so.

What Is a Qualified Annuity?

A qualified annuity is an annuity purchased in certain retirement plans, like a traditional individual retirement account (IRA) or a traditional 401(k).

Here are some of the unique features of a qualified annuity:

- A qualified annuity is funded with pre-tax dollars, meaning you haven't yet paid taxes on the money. Roth retirement plans are funded with after-tax dollars, making them non-qualified annuities.
- When you get money from a qualified annuity, income tax must be paid on the entire amount.
- Typically, you must begin taking required minimum distributions (RMDs) from a qualified annuity by April 1 of the year after they turn 72. Two exceptions to this rule are if the annuity is part of a Roth IRA, or if the annuity is part of an employer-sponsored plan and you're still working.
- The buyer of a qualified annuity must have earned income. Earned income refers to all of the taxable income, such as salary and tips, that you receive when you work for yourself or someone else.
- Annual contributions to a qualified annuity are subject to IRS limits.

What Is A Non-Qualified Annuity?

Anyone can buy a non-qualified annuity regardless of whether they are covered by a workplace retirement plan. Here are some of the unique features of a non-qualified annuity:

- A non-qualified annuity is funded with after-tax dollars, meaning you've already paid taxes on the money. They can be purchased in any Roth retirement account, like a IRA IRA or a Roth 401(k).
- Federal income tax must be paid on the interest or earnings from a non-qualified annuity, but not on the principal and premiums.
- Under federal rules, the owner of a non-qualified annuity does not need to take RMDs at any point. Once withdrawals begin, however, the owner first receives interest or earnings, followed by the amount that was initially deposited—the principal—along with the premiums that were paid.
- The buyer of a non-qualified annuity isn't required to have earned income.
- Annual contributions to a non-qualified annuity are not subject to any IRS limits. However, the provider of the annuity might impose its own limits.

"If you want to use an annuity on non-qualified money, the advantage is that you can defer the taxation on gains until you start receiving the money after age 59-and-a-half," said certified financial planner Greg Lawrence, founder of retirement planning firm Lawrence Legacy Group. "If you are currently in a high tax bracket that will possibly go down later in retirement, this is desirable."

Should You Buy an Annuity?

Either a qualified or non-qualified annuity can provide an income stream for the rest of your life. Both types could appeal to investors, depending on their financial situations.

The benefits of an annuity are pretty powerful: guaranteed lifetime income. The downside, though, is when disaster strikes and your life expectancy is suddenly cut short.

"Annuities are normally a long-term commitment," said wealth management advisor Tiffany Welka, vice president of VFG Associates. "Planning for your future requires a great deal of thought, so you must be sure that you are not going to need to use the funding that you set aside in an annuity in the immediate future."

Consider including annuities in your retirement income plan if you're in good health, and the idea of consistent payments appeals to you.

"If you are trying to get the highest possible returns each year, then annuities are not for you," said Lawrence. "However, if you want steady, predictable returns that can guarantee future income, then … they are good investments."

Before purchasing an annuity, consult a financial planner to figure out the tax implications of this kind of investment and how an annuity fits into your overall investment strategy.

"Generally, investors should never put more than half their retirement into an annuity, no matter how good it performs, as having some liquid assets available is a must in retirement," Lawrence said.

The Bottom Line

The key difference between a qualified annuity and a non-qualified annuity boils down to taxes.

Generally, a qualified annuity is funded with pre-tax dollars, while a non-qualified annuity is funded with after-tax dollars.

Federal income tax must be paid on the full amount of money taken out of a qualified annuity, except if the annuity was in a Roth IRA or Roth 401(k).

By contrast, federal income tax is supposed to be paid only on the interest and earnings from a non-qualified annuity; the principal and premiums aren't taxed.

Under that same framework, a withdrawal from a qualified or non-qualified annuity before age 59½ normally is subject to a 10% tax penalty.

It's worth pointing out that money withdrawn from a qualified annuity is subject to ordinary tax rates (as opposed to long-term capital gains tax rates, for instance). The same holds true for the accumulated earnings and interest that are pulled out of a non-qualified annuity.