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ANNUITIES

# Conversation Guide: The Tax Benefits of Annuities

How to explore a potential role for annuities  
in your clients' retirement tax strategies

People saving for retirement have many reasons to consider making annuities part of their plan. The promise of guaranteed income payments may be especially welcome, and when these guaranteed payments are secured for life, annuity owners can take comfort in knowing they will always have an income source to help cover essential expenses.

Beyond these core benefits, annuities can offer special tax advantages that could help people during both the pre-retirement accumulation phase as well as after retirement when income becomes a priority. To introduce clients to the tax benefits of annuities, financial professionals can pose the following three questions, each of which opens up a deeper discussion about why clients might consider annuities.

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**This conversation guide explores the tax advantages that annuities can offer during the pre-retirement accumulation phase as well as after retirement.**



## Conversation #1. Exploring additional tax-deferred saving options

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### Opening question:

**"Could you use another  
tax-deferred vehicle  
for retirement?"**

**Discussion points:** Tax-deferred investment accounts like 401(k)s and IRAs are powerful retirement savings tools, but there are limits to how much clients can contribute to them each year. In 2021, clients under age 50 can contribute up to \$6,500 per year to an IRA or up to \$19,500 to a 401(k). Clients 50 or older are also allowed \$6,000 for IRAs, but they can contribute up to \$25,500 for 401(k)s.<sup>1</sup>

Those limits essentially place a cap on the total amount of retirement savings that can benefit from tax-deferred growth – unless clients add another source to accumulate funds on a tax-deferred basis.

Non-qualified annuities, meaning those purchased with after-tax money, don't have contribution limits. This feature may make them a valuable additional source of retirement assets for clients who have maximized contributions to their employer-sponsored plan and employer matching program, and also after contributions to IRAs. Once made, annuity purchase payments can benefit from tax-deferred growth until the annuity holder begins making withdrawals.<sup>2</sup> Adding annuities alongside IRAs or 401(k)s could be attractive to clients who want to catch up on their retirement assets or create a potentially larger pool of money for future retirement income.



## Conversation #2. Managing income taxes in retirement

### Opening question:

“Are you concerned about managing your income tax once you start taking distributions from your retirement accounts and Social Security?”

**Discussion points:** Taxes are a critical consideration when developing a retirement income plan. Withdrawals from many of the most common retirement savings vehicles – including traditional IRAs and 401(k)s – are typically 100% taxable at regular income tax rates. What's more, even though Social Security benefits are tax-advantaged compared to 401(k) and IRA withdrawals, many people pay taxes on a portion of their Social Security benefits. Up to 50% of benefits may be taxable for joint filers with a combined income of \$32,000 to \$44,000, while up to 85% of benefits may be taxable for joint filers with a combined income of more than \$44,000.<sup>3</sup>

Maintaining a diversified mix of retirement income sources with different tax treatments can help manage tax bills. For example, annuity income is taxed differently than retirement account withdrawals: For non-qualified annuities (meaning those purchased with after-tax dollars), only the portion of income that comes from earnings is subject to federal income tax, and in some cases, state income tax as well. The return of a client's original purchase payment, on the other hand, is not taxed.

Because of this tax treatment, a portion of annuity income may not be subject to taxes, versus withdrawals from pretax 401(k) and traditional IRA balances or other retirement accounts, which are typically fully taxable. So, blending some annuity income with income from these qualified retirement plans might help lower a client's overall tax bill.

Among other options, clients may choose to use a portion of their savings to purchase an annuity and annuitize the balance – to schedule regular payments for a set term or until the end of life. In the case of a non-qualified annuity, a portion of each payout is considered a tax-free return of the principal investment. In another common scenario, annuity distributions are taxable until the earnings are depleted. After that point, distributions are considered a tax-free return of principal.

The key is to maintain pools of assets in accounts with different tax treatments. That way, financial professionals and their clients can develop an income plan that balances withdrawals from these different sources to help manage their overall tax strategy.



### Conversation #3. Preserving wealth for a long retirement

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#### Opening question:

“Would you like more ways to preserve wealth after age 70?”

**Discussion points:** Traditional IRAs and both traditional and Roth 401(k)s require clients to start taking required minimum distributions (RMDs) at age 72. Not only do distributions from traditional IRAs and 401(k)s trigger income taxes, but failing to take RMDs from all these retirement plans results in a 50% penalty on the amount that was required but not taken. Roth 401(k) distributions are tax free, provided the distribution occurs:

- at least five years after the participant began making Roth deferrals to the plan, and
- after the participant reaches age 59½, or following the participant’s death or disability

For retirees who have the bulk of their savings in qualified retirement accounts, RMDs make it more challenging to preserve wealth. Some annuities can provide a way to leave a portion of savings untouched after age 72. For example, a client might choose to purchase a deferred annuity at age 65 with a plan to take distributions at a future date that suits their retirement income needs – essentially putting pension-like income in place for later in retirement. Another option for clients with IRA assets is to use a portion of that money to purchase a deferred income annuity that’s characterized as a Qualifying Longevity Annuity Contract (QLAC).<sup>4</sup> QLACs allow people to begin receiving income payments at an older age while avoiding payment of some RMDs until as late as age 85. Non-QLAC annuities held within qualified retirement plans are subject to the same RMD rules as other assets in qualified plans.

The ability to preserve wealth and secure a stream of income for later in retirement can make annuities one of the strongest forms of protections against the risk that clients will outlive their retirement savings. Annuities can also play a role in legacy planning, with some annuities providing a death benefit that can be passed to beneficiaries.

## Include tax planning as part of a retirement income discussion

Discussing these questions can help financial professionals and clients incorporate tax planning into their overall retirement income strategy – and help explore potential roles for annuities in those plans. While the primary benefit of annuities remains their income features, annuities can also deliver important tax benefits. By offering another way to defer taxes when growing retirement assets, and then providing additional opportunities to defer taxes when it's time to turn those assets into income, annuities can help clients manage their tax bill in retirement and keep more money for themselves.

A comprehensive retirement income strategy that takes into account these important tax considerations can help clients decide what type of annuity may be right for them. And once that piece is in place, the benefits that an annuity provides can help them feel more confident about their ability to achieve the retirement lifestyle they've envisioned.

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<sup>1</sup> 2021 Annual Contribution Limits. FINRA, 2021.

<sup>2</sup> If the client is buying an annuity to fund a qualified retirement plan or IRA, they should do so for the annuity's features and benefits other than tax deferral. Tax deferral is generally a feature of a qualified retirement plan or IRA, so an annuity would not provide an additional tax deferral benefit. References throughout this material to tax advantages, such as tax deferral and tax-free transfers, are subject to this consideration. The product described in this material is not made available to employer-sponsored qualified retirement plans. For non-qualified annuities, tax deferral is not available to corporations and certain other entities.

<sup>3</sup> Benefits Planner: Income Taxes And Your Social Security Benefit. Social Security Administration, 2021.

<sup>4</sup> A QLAC does not make available any commutation benefit, cash surrender right, or other similar feature. Adhering to the purchase limit is the client's responsibility. Clients should consult with their own independent legal and tax professionals prior to establishing a QLAC. Brighthouse Financial cannot provide tax advice.

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Withdrawals of taxable amounts are subject to ordinary income tax. Withdrawals made before age 59½ may also be subject to a 10% federal income tax penalty. Distributions of taxable amounts from a non-qualified annuity may also be subject to the 3.8% Net Investment Income Tax that is generally imposed on interest, dividends, and annuity income if the modified adjusted gross income exceeds the applicable threshold amount. Withdrawals will reduce the death benefit and account value. Withdrawals may be subject to withdrawal charges.

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