

Annuities vs. CDs: Which Retirement Income Strategy is Best?

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Explore the key differences between annuities and CDs, focusing on tax deferral benefits and income distribution flexibility for optimal retirement planning.

By Ronnie Thompson

Determining how you'll receive income in your golden years is the pinnacle to securing financial stability. Annuities and CDs are investment vehicles that can help you achieve this. However, depending on your individual goals, one product might work better than the other. If you're looking for a tax-advantaged investment with a higher fixed rate of return that can provide additional asset protection, an annuity might be the answer.

Annuities are investment products, typically offered by insurance companies, that provide you with a stream of income in exchange for premiums paid. Unlike a life insurance policy, which only pays benefits once the policyholder dies, these financial contracts typically provide a main income stream in retirement.

A CD, on the other hand, is a type of savings account, typically offered through a bank, where you contribute money for a fixed period of time. CDs offer a fixed interest rate with a higher rate of return than a traditional savings account. However, access to the funds are limited until the account reaches maturity.

As a financial adviser, there are a few reasons why I'd recommend an annuity over a CD to my clients.

Annuities Are Tax-Deferred

One of the biggest and most substantial differences between annuities and CDs is the way they're taxed.

The first and most important thing to consider when it comes to taxation is the registration

of the money being invested. If the money being invested is “pretax” such as an Individual Retirement Account (IRA), both a CD and annuity will be treated the same for tax purposes. If the money remains in an IRA structure, the tax is “deferred” until a withdrawal is made from the investment. Once a withdrawal is made, income tax will be assessed on the entire distribution amount.

If the investment made is “post-tax,” meaning income tax was already paid on the investment, this is where CD’s and annuities are treated differently when it comes to tax. While the interest earned on both of these investment strategies is taxed as ordinary income by the IRS, when you are taxed varies. When it comes to CDs, the tax on your interest is reported each year you earn interest and is owed that tax year. With an annuity, the tax is reported at the end of the term or when you make a withdrawal or reinvest the funds in another product. Deferring the tax until the end results in a higher NET return on your money as opposed to owing a tax each year as you would with a CD.

Withdrawals from “after-tax” annuities apply the “last in first out” or “LIFO” rule. When making an investment into an annuity “first in” is considered the investment or deposit made. “Last in” is the interest the investment earns. LIFO means that the interest or taxable portion of the investment is the “first out” when taking a withdrawal. Therefore, any withdrawals made from an annuity will require the interest portion or taxable portion of the annuity to be distributed before any of the nontaxable principle is distributed.

Annuity investors do have the option to keep the money in the annuity once the term has ended at a new stated interest rate, or rollover or direct transfer the funds to another annuity. The IRS does not consider this a taxable event, allowing you to continue deferring the taxes owed on interest.

The benefit of tax deferral in an after-tax annuity does come with some restrictions. If an investor invests money into an after-tax annuity, the deferred tax applies the age 59 ½ early withdrawal penalty. This means if the investor is under the age of 59 ½ and takes a withdrawal from the account, a 10% penalty is applied on top of the taxes owed. This makes age and the need for funds an important factor when considering an after-tax annuity.

Tax-deferral can be a huge benefit when it comes to long-term retirement planning. Many of the clients I work with are looking to preserve and protect assets they have earmarked for retirement and want to grow it safely in a fixed interest environment. For these clients, tax-deferral allows them to defer the taxes until they retire, which typically results in a lower tax-bracket since they’re no longer generating reportable income from their salary.

This allows the client to pay a lower tax rate on the gains they earned in these accounts prior to retirement.

Annuities Offer More Options for Income Distribution

For CD investors, the options are limited when it comes to income distribution. CDs only offer two options for taking income: taking income as needed from the CD or taking the funds in a lump-sum form from the CD. Annuities, however, offer many additional options. Those options include fixed period or period certain, income for life, life income with period certain, joint or survivor life, cash refund and lump-sum. These options are designed to cover an array of specific needs, making them a powerful tool when adding fixed income to a portfolio. This can reduce the stress that comes with traditional market-related options while also creating a higher probability of your income lasting through your retirement years. Annuities are considered to be 'insurance-related' strategies, which means they're designed to create income a client cannot outlive.

Annuities Provide An Additional Layer of Asset Protection

In addition to providing you with income you cannot outlive, annuities' insurance-related nature can also protect assets from creditors, lawsuits and even bankruptcy. However, it should be noted that annuities are regulated under state laws so refer to your state laws to get an idea of how much protection your annuity provides.

Depending on the type of annuity you have, they can also protect against market risk. For example, fixed annuities offer guaranteed returns, protecting you from market downturns. Indexed annuities are similar, however, the interest yield return is partially based on market performance. This gives investors the potential to earn a higher investment return than a traditional fixed-rate annuity while still offering some protection from market downturns.

And since annuities depend on the financial strength of the insurance company they are issued by, state guaranty associations may also offer limited protection if the company fails—typically up to \$250,000.

Annuities can also ease the transfer of assets when it comes to estate planning. As long as the annuity has a named beneficiary listed, the funds can usually be transferred directly to the beneficiary, avoiding probate. Some annuities even allow a spouse beneficiary to continue the contract, thus delaying taxes and avoiding probate.

For retirees looking for a stable income stream that provides tax advantages and increases asset protection, annuities might be a great addition to their portfolio. However, keep in mind that there are a wide range of financial products out there that come with their own

benefits and drawbacks. To create a portfolio that is designed with your specific financial needs and goals in mind, consult with a financial adviser.

About the author: Ronnie Thompson

Ronnie Thompson is a financial adviser and owner of True North Advisors. He opened the firm back in 2007 as an estate planning and wealth management firm. Having advised through economic downturns combined with his overwhelming knowledge of the industry and willingness to educate his clients every step of the way is the backbone of his practice. Ronnie lives with his wife Kristy and their three amazing children: Esmie, Tobin and Tye.