INSURED RETIREMENT INSTITUTE

Annuity Basics

Optimizing Tax-Deferred Investing and Retirement Income Using Variable Annuities

Key Learnings

- Variable annuities offer significant tax advantages relative to mutual funds over longer holding periods, even after accounting for lower taxes on dividends and long-term capital gains.
- The tax advantages of variable annuities are amplified when holding tax-inefficient investment options, for example bonds funds and high turnover equity open-end funds.
- When income is generated from a variable annuity using annuitization, the investor obtains meaningfully higher income after a deferred investment period than what can be safely obtained from a mutual fund portfolio.
- By maximizing income using a deferral and annuitization strategy for a portion of client assets, more aggressive investment of the remaining assets is possible, driving higher overall asset growth over time.

Taxation of Mutual Funds and Variable Annuities

Investments in mutual funds can be held in tax-deferred or taxable accounts. Either can be funded in one of two ways:

1. With pre-tax dollars (e.g., through qualified plans such as 401(k) and IRA accounts)
2. After-tax dollars as when investing in mutual funds outside of qualified plan, or in a Roth IRA or Roth 401(k)

When investments are made in a qualified plan with pre-tax dollars (or after-tax dollars in the case of a Roth IRA or Roth 401(k)), withdrawals are taxed using ordinary income tax rates. The lower tax rates applicable to capital gains are not available. However, long-term capital gains and dividends are taxed at lower rates in non-annuity taxable accounts, while only interest income is subject to ordinary income tax rates. All interest, dividends, and capital gains are taxed at ordinary income rates in a variable annuity.

The following illustrations show how a variable annuity can be used to generate better after-tax returns and higher income than a similar portfolio of mutual funds.

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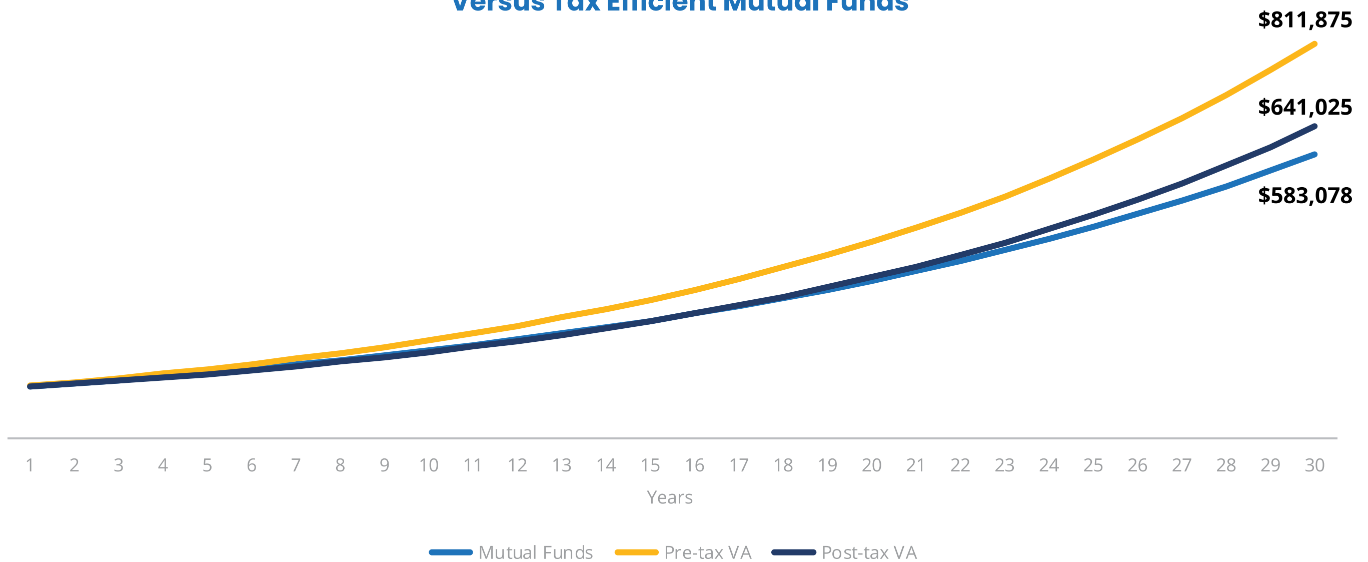
Section I: Variable Annuity Versus Tax Efficient Mutual Funds

The after-tax value of a variable annuity will eventually surpass the after-tax value of a mutual fund portfolio. This is due to the deferral of taxes on variable annuity earnings until monies are withdrawn or the variable annuity is converted to lifetime income, either by annuitizing or exchanging into an immediate annuity. The lower tax rates applicable to long-term capital gains and dividends provide tax efficiency for the mutual fund portfolio, so it takes several years for the variable annuity to "catch up" and overcome the higher ordinary income tax rate on all returns. Figure 1 compares a variable annuity to a mutual fund portfolio using the following return assumptions, with the variable annuity exceeding the value of the mutual fund portfolio in about 16 years. (A full discussion of the assumptions used in the illustrations may be found in the Appendix).

1. An initial investment of $100,000;
2. 30-year holding period;
3. An eight percent compound rate of return; and,
4. Investment returns taxed using an ordinary income tax rate of 24 percent for interest and short-term capital gains and 15 percent for dividends and long-term capital gains.



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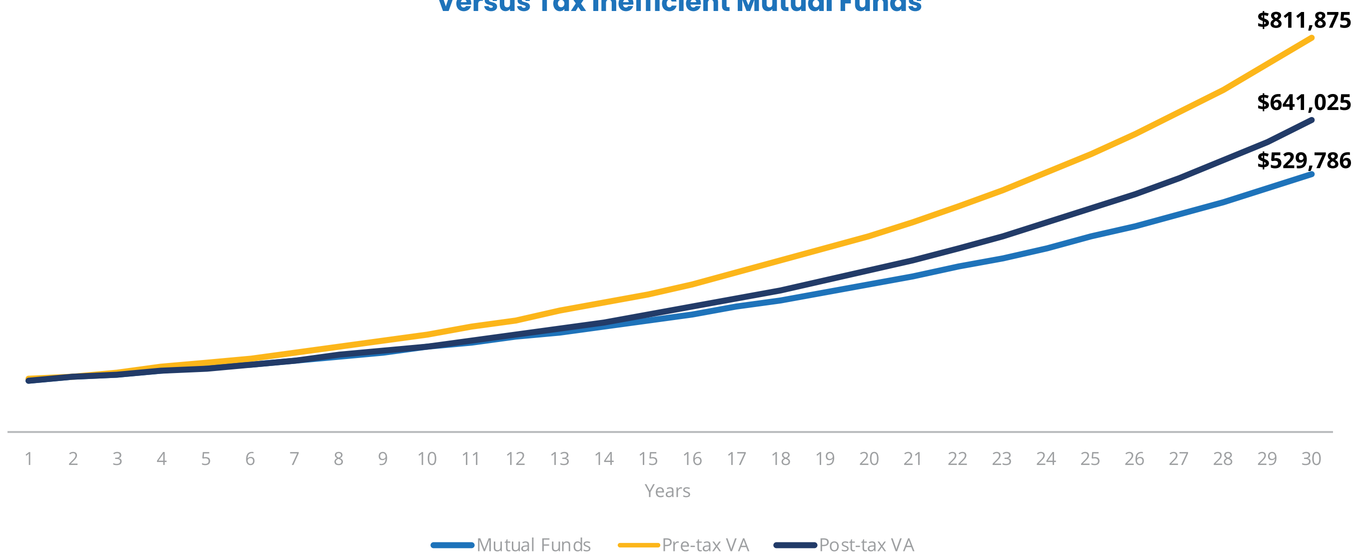
Section II: Variable Annuity Versus Tax Inefficient Mutual Funds

When tax inefficient investments are held in a variable annuity, the tax advantages relative to a mutual fund portfolio are even greater. Returns on bond funds, private placements, and alternative investments such as commodities funds and derivative strategies are generally taxed at ordinary income tax rates, which can be as high as 37 percent, and state and local income taxes can increase the effective rate to 50 percent at the highest income levels in some cities and states. Figure 2 uses the same assumptions as Figure 1, except that all investment returns are taxed at a conservative ordinary income tax rate of 24 percent. The mutual fund portfolio in Figure 2 is less tax efficient than the portfolio in Figure 1, so the liquidated variable annuity breaks even with the mutual fund portfolio in just six years. It is important to note, however, that while Figures 1 and 2 show an after-tax VA value based on a 24 percent tax rate, the liquidation would have to be spread out over several years to avoid triggering the much higher marginal tax rates associated with receiving a large amount of taxable income in a single year.

Figure 2: Fully Liquidated Variable Annuity Versus Tax Inefficient Mutual Funds



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Section III: Optimizing Tax Deferral and Creating Lifetime Income

The variable annuity produces annual pre-tax lifetime income equal to 7.2 percent of the amount annuitized. The annual withdrawals from the mutual fund portfolio are matched to that annuitized income, but cannot sustain it past age 84. The variable annuity provides more total income, and eliminates the risk that financial resources will not be depleted prior to death.

Figure 3 compares the after-tax income realized by a hypothetical non-qualified investment of $100,000 held for 15 years in a portfolio of mutual funds and a variable annuity; the initial investment is made at age 50 and income begins at age 65. Two income streams are represented in the chart.

1. Cash refund annuitization of the variable annuity (which can be done within the contract or via 1035 exchange to an immediate annuity); and,
2. Systematic withdrawals from a mutual fund porftolio.

A data table with a summary of the chart values appears below the illustration, and both the variable annuity and mutual fund portfolio values are calculated using the same methodology as in Figure 2.

Figure 3 Comparison of Income Generated by a Variable Annuity Versus Mutual Funds

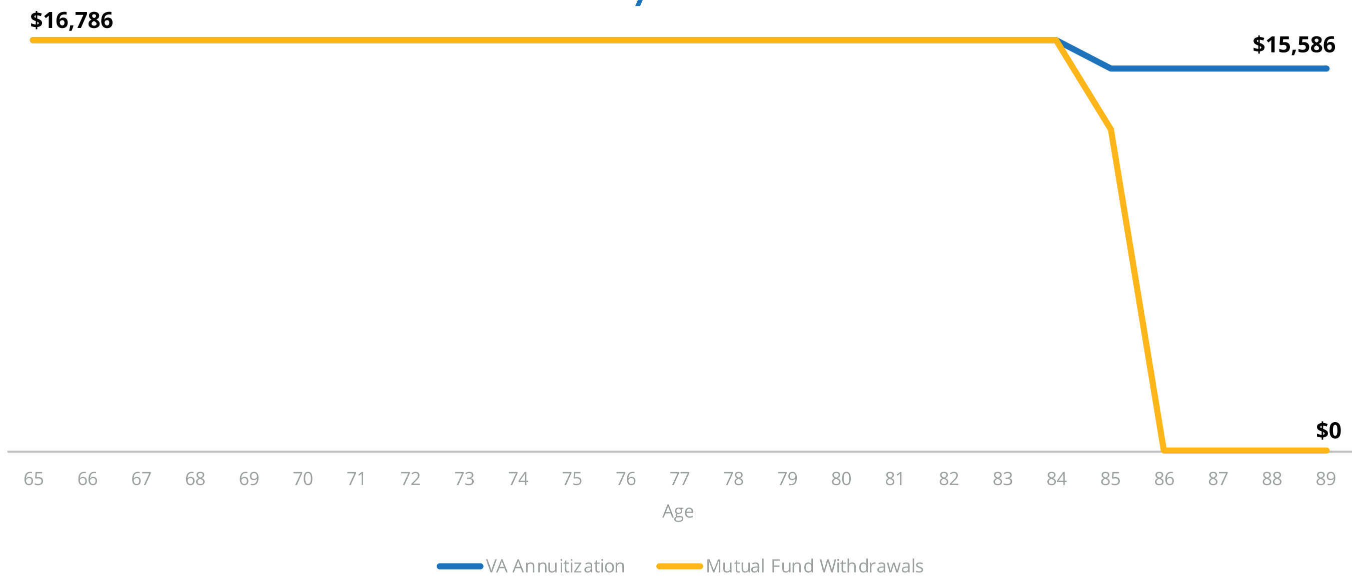

Figure 3 Data Table

	VA Annuity Income		**Mutual Fund Portfolio Withdrawals**	
End of Year	***Variable Annuity Value***	***After-Tax Annual Annuity Income***	***Portfolio Value***	***After-Tax Annual Withdrawals***
1	$107,230		$105,715	
15	$284,934		$230,171	
16 (Age 65)	$0	$16,786	$222,336	$16,786
20 (Age 69)	$0	$16,786	$187,571	$16,786
25 (Age 74)	$0	$16,786	$135,253	$16,786
30 (Age 79)	$0	$16,786	$71,002	$16,786
35 (Age 84)	$0	$16,786	$0	$9,585
36 (Age 85)	$0	$15,586	$0	$0

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The annuitant is assumed to be a male aged 65 who either annuitizes the variable annuity or exchanges it for an immediate annuity making lifetime income payments with cash refund. With cash refund annuitization, if the annuitant dies prior to recovering the initial investment, the beneficiary receives a payment of the initial investment less payments made prior to death. For the first 20 years, a portion of the annuitized amount is not taxed; this is considered a return of principal and is called the exclusion ratio. The life expectancy of a 65-year-old male is 20 years, so a portion of the annuitized amount is excluded from taxation each year for 20 years, after which the full payment is taxable and after-tax income is lower. However, and importantly, the annuitized income continues for the life of the annuitant, whereas the mutual fund portfolio is depleted after 21 years, or at age 85.

Summary

Time and annuitization are the keys to optimizing tax deferred investing in variable annuities. If a portion of the portfolio is allocated to a variable annuity several years prior to planned retirement, the compounded growth of the investments within the annuity will produce a higher income amount than can be safely withdrawn from a mutual fund portfolio, and the income will continue for life. When this is done from a financial planning perspective, securing income for basic expenses, the remainder of the portfolio can be allocated more aggressively to growth-oriented investments as it will not need to be used for income.

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Appendix

Income Illustration Assumptions

> The initial after-tax investment is $100,000 and there are no subsequent investments.

> The contract owner's taxable income is between $100,526 and $191,950 (single) or $201,051 and $383,900 (married filing jointly) per year.

> The ordinary income tax rate is 24 percent, applicable in 2024 to income above $201,050 and below $383,901 for a married couple filing jointly (in the progressive U.S. tax system, tax on ordinary income may be higher or lower than 24 percent at the margin but the rate is kept constant to simplify the analysis and avoid using the top brackets of 32, 35, and 37 percent, which would unrealistically favor the annuity).

> Long term capital gains and qualified dividend income are taxed at 15 percent (rate applicable to married filing jointly income of $94,055 to $583,750 per year).

> Gains in the mutual fund portfolio are taxed as 50 percent ordinary income and 50 percent dividend/long-term capital gains based on the weighted average turnover ratio of 24,488 mutual fund share classes in the Morningstar database that meet the criteria of having reported assets under management and being available for new investment.

> The gross annual return for both the variable annuity and the mutual fund portfolio is 8 percent during the accumulation period. When distributions begin the mutual fund portfolio gross return is reduced to 6 percent based on the assumption that the portfolio would be more heavily weighted toward conservative investments, especially in the current interest rate environment. It would not be unfair to assume an even lower return in the mutual fund portfolio both prior to and after the start of income; according to 2019 research by DALBAR, Inc., the average subaccount investor outperformed the average mutual fund investor by 75 basis points or more in each of the prior five years, and outperformed investors overall in each of the prior 10 years. However, to illustrate using conservative assumptions returns are set to equivalent rates.

> Total annual expenses for the variable annuity are 0.77 percent. This is the weighted average of the contract and underlying fund expenses (total expenses net of contractual waivers and reimbursements) for contracts that do not offer death or living benefits, which creates an "apples-to-apples" comparison as there are no expenses for lifetime withdrawal or death benefits, the values of which are not reflected in the analysis.

> Total annual expenses for the mutual fund portfolio are 0.48 percent, calculated as the weighted average of total fund expenses, less contractual waivers and reimbursements.

> Both the variable annuity and mutual fund expenses assume investments are held in a fee-based account, therefore commissionable products are excluded from the analysis.

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