# UNDERSTANDING VARIABLE ANNUITIES

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# THE STEP-UP IN BASIS ISSUE

The following chart shows what the net ending value of a $50,000 mutual fund and variable annuity investment would be worth ten years from now factoring in all costs and taxes if the IRC §691 deduction is not available.

| DATA | MUTUAL FUND | VARIABLE ANNUITY |
|---|---|---|
| (1) Initial Investment | $50,000 | $50,000 |
| (2) Value at Death (Age 82) | $86,481[1] | $98,634[2] |
| (3) Other Taxable Estate | +$1,500,000 | +$1,500,000 |
| (4) Total Taxable Estate | $1,586,481 | $1,598,634 |
| (5) Federal Estate Tax | -0- | -0- |
| (6) Estate to Grandchildren | $1,586,481 | $1,598,634 |
| (7) Grandchildren's Income Taxes | -0- | -$9,727[3] |
| (8) Estate to Grandchildren | $1,586,481 | $1,588,907 |

[1] $50,000 – 4% = $48,000 + 10% = $52,800 – 2.2% = $51,638 - $48,000 =$3,638 – 20% = $2,911 ÷ $48,000 = 6.064% x 10 years x $48,000 = $86,481.

[2] $50,000 x 10% = $55,000 – 2.7% = $53,515 - $50,000 = 3,515 ÷ $50,000 = 7.03% x 10 years x $50,000 = $98,634.

[3] $48,634 gain x 20% = $9,727 (The grandchildren would most likely have an average tax rate of less than 20%).

# THE STEP-UP IN BASIS ISSUE

The following chart shows what the net ending value of a $500,000 mutual fund and variable annuity investment would be worth ten years from now factoring in all costs and taxes if the IRC §691 deduction is not available.

| DATA | MUTUAL FUND | VARIABLE ANNUITY |
|---|---|---|
| (1) Initial Investment | $500,000 | $500,000 |
| (2) Value at Death (Age 82) | $882,827[1] | $986,337[2] |
| (3) Other Taxable Estate | +$1,500,000 | +$1,500,000 |
| (4) Total Taxable Estate | $2,382,827 | $2,486,337 |
| (5) Federal Estate Tax | -0- | -0- |
| (6) Estate to Grandchildren | $2,382,827 | $2,486,337 |
| (7) Grandchildren's Income Taxes | -0- | $97,267[3] |
| (8) Estate to Grandchildren | $2,382,827 | $2,389,070 |

[1] $500,000 – 2% = $490,000 + 10% = $539,000 – 2.2% = $527,142 - $490,000 = $37,142 – 20% = $29,717 ÷ $490,000 = 6.064% x 10 years x $490,000 = $882,827.

[2] $500,000 x 10% = $550,000 – 2.7% = $535,150 - $500,000 = $35,150 ÷ $500,000 = 7.03% x 10 years x $500,000 = $986,337.

[3] $486,340 gain x 20% = $97,267 (The grandchildren would most likely have an average tax rate of less than 20%).

# IRC §691 IRD EXAMPLE

The following chart shows what the net ending value of a $50,000 mutual fund and variable annuity investment would be worth ten years from now factoring in all costs, taxes and the IRC §691 deduction.

| DATA | MUTUAL FUND | VARIABLE ANNUITY |
|---|---|---|
| (1) Initial Investment | $50,000 | $50,000 |
| (2) Value at Death (Age 82) | $86,481[1] | $98,634[2] |
| (3) Other Taxable Estate | +$5,450,000 | +$5,450,000 |
| (4) Total Taxable Estate | $5,536,481 | $5,528,634 |
| (5) Federal Estate Taxes | -$34,592[3] | -$39,454[4] |
| (6) Estate to Grandchildren | $5,501,889 | $5,509,180 |
| (7) Grandchildren's Income Taxes | -0- | -$9,727[5] |
| (8) Estate to Grandchildren | $5,501,889 | $5,499,453 |
| (9) IRC §691 Adjustment | -0- | +$3,891[6] |
| (10) Net Amount to Grandchildren | $5,501,889 | $5,503,344[7] |

*If the estate is valued at less than $5.45 million, the beneficiaries of the variable annuity would still receive more. $98,634 - $3,891 (income tax) = $94,743 vs. $86,481.

[1] $50,000 - 4% = $48,000 + 10% = $52,800 - 2.2% = $51,638 - $48,000 = $3,638 - 20% = $2,911 ÷ $48,000 = 6.064% x 10 years x $48,000 = $86,481.

[2] $50,000 x 10% = $55,000 - 2.7% = $53,515 - $50,000 = $3,515 ÷ $50,000 = 7.03% x 10 years x $50,000 = $98,634.

[3] 40% of $86,481 = $34,592.

[4] 40% of $98,634 = $39,454.

[5] $48,634 gain x 20% = $9,727 (The grandchildren would most likely have an average tax rate of less than 20%).

[6] The variable annuity gain of $48,634 is 49.308% of the full value of the variable annuity at death ($98,634), therefore 49.308% of the estate tax of $39,454 or $19,454 is the IRD deduction. The grandchildren's income tax would be calculated on $29,180 ($48,634 - $19,454) not $48,634. The income tax liability would be $5,836 at 20% not $9,727. This is a difference of $3,891.

[7] If these were qualified accounts the variable annuity would provide more to the grandchildren.

# OTHER STEP-UP IN BASIS TOPICS

- **THE STEP-UP THAT MOST MUTUAL FUND OWNERS THINK THEY HAVE IS ACTUALLY MUCH SMALLER.**
- **THE STEP-UP IN BASIS MAY SOON BE ELIMINATED.**
- **THE STEP-UP IN BASIS DOES NOT APPLY TO QUALIFIED ACCOUNTS.**
- **MUTUAL FUNDS HAVE STEP-DOWN IN BASIS, VARIABLE ANNUITIES DO NOT.**
- **TO GET A STEP-UP IN BASIS ONE MUST DIE WITHOUT USING HIS MUTUAL FUND PORTFOLIO.**
- **THE SPOUSAL CONTINUATION PROVIDED BY VARIABLE ANNUITY COMPANIES IS, IN MANY CASES, A BETTER ECONOMIC BENEFIT THAN A STEP UP IN BASIS.**
- **STEP-UP ELIMINATES INCOME TAXES ONLY IF THERE IS GAIN. EEB ELIMINATES INCOME OR DEATH TAXES OR YOU CAN KEEP THE MONEY.**
- **ANNUITIZATION CAN PRODUCE LARGER NET RESULTS THAN A STEP-UP IN BASIS.**
- **IRC §1035 CAN BE USED TO DRAMATICALLY INCREASE THE DEATH BENEFIT OF VARIABLE ANNUITIES AND PROVIDES MORE TO BENEFICIARIES THAN A STEP-UP WITH MUTUAL FUNDS.**

# THE COST ISSUE

The hard costs of *annual* ownership: The average non-qualified A-share equity mutual fund (Assuming the fund returns 10% annually and was purchased for $20,000)

| COSTS | AVG. M.F. | AVG. V.A. |
|---|---|---|
| Money Mgmt. Fees | 1.30% | 0.75% |
| Annual Expense Ratio and 12b-1 Fees | 0.25% | 0.25% |
| Mortality and Expense | 0.00% | 1.25% |
| Annual Income Taxes | 1.45% | 0.00% |
| Trading Costs | 0.70% | 0.60% |
| Annualized 5% Commission (5 year hold) | 1.00% | 0.00% |
| Total | 4.70% | 2.85% |

- *The Great Mutual Fund Trap* (Bear and Gensler)
- *Your Money, Your Choice ... Mutual Funds: Take Control Now and Build Wealth Wisely* by Professor Charles P. Jones
- *Stop Wasting Your Wealth In Mutual Funds* by Don Wilkinson.
- A recent detailed study by Tom Roseen of Lipper, Inc., found that the typical mutual fund lost about 20% of its net (after-load, after expenses) annual gain each year to income taxes.
- The O'Neal study (Wake Forest - 2002) found that the true annual cost of mutual funds was approximately twice the stated annual expense ratio of any given fund before annual income taxes are added.
- Morningstar recently reported (*The Wall Street Journal*, April 3, 2008) that the before and after tax gap for large cap mutual funds was 3.4%.
- See Trading Cost article in *The Wall Street Journal*, March 1, 2010, Sec. 'C'.

# THE ANNUAL INCOME TAX ISSUE

- Tax Advice v. Tax Facts
- Deductibility of variable annuity losses
- A mutual fund distribution made that is half long-term capital gain and half ordinary income to a mutual fund investor in a 33% average income tax bracket results in a *minimum* income tax of 24% on the distribution.
- Mutual fund taxes considering flat and down years:

| | | | | | | |
|---|---|---|---|---|---|---|
| $50,000 | → | $70,000 | and generates a tax of | $2,550 | on a distribution of | $17,000 |
| $50,000 | → | $50,000 | and generates a tax of | $1,500 | on a distribution of | $10,000 |
| $50,000 | → | $34,500 | and generates a tax of | $ 450 | on a distribution of | $3,000 |
| $150,000 | | $154,500 | | $4,500 | | |

Gain $4,500 - $4,500 = 0 (100% tax!)

# INCOME TAXATION OF WITHDRAWALS

- **Making financial decisions "at the margin" can be misleading.**

  Betty wants to purchase a new sports car. She is very concerned with fuel costs. One car she is considering has a 15 gallon gas tank. Gas costs $3.00 a gallon. An identical sports car has the same size gas tank but requires a quart of special additive be added to the car every time the gas tank is filled. A quart of gas cost 75¢ ($3.00 ÷ 4), however a quart of the special additive costs $1.50. Which statement is true?:

  - It cost twice as much to fill the gas tank on the second sports car as it does the first.

  - The cost to fill the entire gas tank on the first sports car is $45.00 ($3.00 x 15) and $45.75 ($3.00 x 14¾ + $1.50) to fill the gas tank of the second car.

# INCOME TAXATION AT WITHDRAWAL

- **Marginal Tax Rate Errors:** Mike and Mary are 61, married and retired. Their gross retirement income is $84,350. Their exemptions and deductions are $14,000. Their taxable income is $70,350. At this level of taxable income, Mike and Mary are in a 15% marginal tax bracket. Mike recently withdrew $5,000 from a non-qualified annuity he had raising their taxable income to $75,350 and putting Mike and his wife in a 25% tax bracket for 2016. The entire withdrawal is subject to ordinary income taxation. What amount of Mike's variable annuity withdrawal is subject to a 25% tax.

**The 8% Rule:** Subtracting 8% from one's marginal tax rate will yield a much closer estimate of a typical client's tax liability. The difference between marginal tax rates and average tax rates is, on average at least 8%. For example, a taxpayer can be in a 28% marginal tax bracket but pay taxes at a 20% average/effective rate.

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$0 - $18,550 @ 10%; $75,300 - $18,550 = $56,750 @ 15%; $75,350 - $75,300 = $50 @ 10% additional = $5.

The income tax on $75,350 is $10,380 (2016) ÷ $75,350 = 13.78%.

# The $100K Rule Dramatically Reduces the "Benefit" of the 15% Long-Term Capital Gains Tax Rate

**THE $100K RULE: A couple earning $100,000 in adjusted gross income with normal deductions and exemptions will have a tax liability to the IRS of 15%.**

| | |
|---|---|
| Pension or other Income, Rentals, Taxable Social Security, etc. | $95,600 |
| Variable annuity withdrawals (Profits only – No Annuitization) | $12,000 |
| Gross Income | $107,600 |
| Itemized Deductions | $15,000 |
| Exemptions | $8,100 |
| Taxable Income | $84,500 |
| Income Tax from IRS Tables for 2016 | $12,668 |

$12,668 income tax liability ÷ $84,500 taxable income = 15%

NOTE: If *all* of the income in the above example came solely from variable annuity withdrawals the income tax would be 15%.

# LIQUIDITY ISSUE

- Cost of liquidity is the issue, not liquidity.
  - Cost of liquidity after 39 months of a flat market. $25,000 investment.

    (The variable annuity has surrender fees of 6% that decline 1% a year over 6 years).

    - A-share mutual fund = _____ + _____ = _____
      (in) (out)
    - C-share mutual fund = _____ + _____ = _____
      (in) (out)
    - Managed money = _____ + _____ = _____
      (in) (out)
    - Variable Annuity = _____ + _____ = _____
      (in) (out)
- Most variable annuities offer surrender periods from zero to seven years or more.
- Pick the surrender period that works best with the client's needs.

# ASSET SUBSTITUTION

- Mutual Fund (Jill)
  - 67 year-old widow with 3 sons
  - $6.45 million estate ($1 million mutual funds)
  - At death with a step-up:
    - IRS gets $400,000
    - Sons get $6,050,000

- Variable Annuity (Jack)
  - 67 year-old widow with 3 daughters
  - $6.45 million estate ($1 million variable annuity with lots of appreciation)
  - Asset substitution:
    - Buy $1,000,000 life insurance policy (daughters own)[$30,000 premium]
    - Swap $1,000,000 variable annuity for a straight life immediate annuity
      - $60,000/yr. income [$30,000 after insurance premium]
      - Exclusion ratio

# ASSET SUBSTITUTION -- CONTINUED

- At death with asset substitution
  - The daughters pay no income taxes
  - There are no federal death taxes ($400,000 with a mutual fund step-up)
  - There are no gift taxes
  - Daughters get $6,450,000 (vs. $6,050,000 with a step-up)
  - Dad gets $60,000/year tax advantaged guaranteed income for life [$30,000 after premium]

- Advantage to producer
  - $100,000+ in commission for each client helped

**[NOTE:** The above examples demonstrate that a little estate planning can get results that are far superior to the step-up in basis available with mutual funds. It should also be noted that it was assumed that Jack's variable annuity would grow to the same amount as Jill's mutual fund would. In reality, Jack's variable annuity would grow to a larger amount due to tax deferral.]