In Focus

The Pluses and Minuses of Variable Annuities

Choosing the Right Options for the Planning Situation

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In Brief

Many CPAs have a general distrust or dislike of variable annuities, but these can be a useful component of a financial plan if they are used properly. Variable annuities can include enhanced benefit riders that are tailored to meet an individual's specific needs. This article discusses the positives and negatives of variable annuities, summarizes some common enhanced benefit options, and suggests planning situations where they might be a useful component of a financial plan.

Many CPA financial planners are skeptical about variable annuities. This article will discuss the positives and negatives of variable annuities in general and enhanced benefit riders specifically, and it will illustrate how they can be used in different financial planning scenarios. Those who keep an open mind may find that these products can work for their clients.

Variable annuities, as defined by the SEC, are contracts between an individual and insurer under which an individual receives periodic payments over the duration of their lifetime, along with a death benefit and the benefit of tax deferral until withdrawals are made. Variable annuity contracts are purchased at once or over time, and a variable annuity can offer a range of investment options, typically mutual funds. Potential purchasers of a variable annuity must be aware that the account value may decrease. They should understand the annuity's features and associated fees and expenses, and be aware of the potential tax consequences.

Positives and Negatives of Variable Annuities

The following are typical criticisms of variable annuities and the author's typical response to such criticism.

Variable annuities are extremely expensive. Variable annuities, with the enhanced lifetime income and death benefits that the author usually recommends, have a cost reported to the client under securities regulations of approximately 3.5–4%. This is significantly higher than the typical mutual fund or managed account fees. But note that the costs for each annuity product are different: it is critical to review the expenses of each annuity proposal carefully and make certain that all fees for desired riders are included.

Variable annuities held inside retirement accounts provide no additional tax-deferral benefit. While it is true that IRAs or qualified plans already offer tax deferral, the author disagrees that this means that an individual purchasing an annuity inside a retirement account is paying for tax deferral that they do not need. If a variable annuity were suggested to a qualified plan participant as providing additional tax deferral, that is an inappropriate sales strategy. However, for many individuals, a retirement plan is the major or sole source of retirement assets, and an annuity may be an appropriate option for that retirement account. The individual will need to determine if the costs are outweighed by the benefits of the particular annuity. According to a 2012 Morningstar report, approximately two-thirds of annuity sales were inside an IRA or other qualified plan.

Variable annuities held outside retirement account are tax inefficient. Critics are convinced that annuities convert capital gain and dividend income to ordinary income, thereby foregoing the preferential capital gain rate. I find it interesting that the detractors of variable annuities often make the argument that qualified plan owners are paying extra for tax deferral that is not needed, but then counter that an unqualified plan owner actually has a tax detriment due to the conversion of dividends and capital gains to ordinary income—without discussing the corresponding tax benefit of deferral. Each annuity buyer needs to review his own situation, and determine if paying tax on dividends, interest, and capital gains currently will result in a higher or lower after-tax cash flow than deferring the tax and paying tax at ordinary income tax rates in later years. If the annuitant is currently in a high tax bracket or paying the net investment income tax (NIIT), she may pay less taxes overall in retirement, even at ordinary rates. Again, this is a case-by-case analysis.

Variable annuities are not a good asset to inherit. Variable annuities are generally an estate asset, and may result in an estate tax. (Due to the increased estate tax threshold, this is not as significant of an issue for most individuals, who will not have a taxable estate.) There will be no step-up in basis for an annuity, similar to

EXHIBIT 1
Guaranteed Living Benefits

Generic insurance company indicates that its guaranteed withdrawal benefit amount will be the higher of the withdrawal benefit shown at the end of the past year plus 6%, or the current anniversary value. Assuming the underlying investments after expenses are positive 10% in year 1, negative 15% in year 2, and positive 10% in year 3, the guaranteed withdrawal benefit amounts (GWBA) will be computed as follows for a $100,000 investment made April 15, 2015:

Date	Contract Value	GWBA
April 15, 2015	$100,000	$100,000
April 15, 2016	$110,000	$110,000*
April 15, 2017	$ 93,500	$116,600†
April 15, 2018	$102,850	$123,596‡

* Because the contract value on the first anniversary exceeds 106% of prior year GWBA, the contract value at the anniversary date becomes the GWBA.
† Because the contract value on the second anniversary is less than 106% of the prior year GWBA, the new GWBA is equal to prior year GWBA × 106% ($110,000 × 106%).
‡ As the contract value on the third anniversary is less than 106% of the prior year GWBA, the new GWBA is equal to prior year GWBA × 106% ($116,600 × 106%).

At the end of year 3, the annuity owner would be guaranteed withdrawals of $6,180 per year (5% of GWBA) for her lifetime. In this example, the guaranteed lifetime withdrawal is approximately 6% ($102,850 × 6% = $6,171) of the contract value, much higher than typically referenced safe withdrawal rates of 4–5%.

GWBA = guaranteed withdrawal benefit amounts an IRA or qualified retirement plan; the heir will pay income tax on amounts paid from the annuity. If estate tax is due, the income may be partially offset under the income in respect of decedent rules.

Trust planning is not available for annuities. Trusts are allowed to own annuities and receive full tax benefits pursuant to IRC section 72(u), if the trust is properly structured to allow for an individual to be deemed a beneficial owner of the annuity. A full analysis of this topic is beyond the scope of this article.

Only limited death benefit options are available in a variable annuity. Contrary to popular perception, most annuities offer a great deal of flexibility in how benefits are paid at death. I have used annuities specifically to meet my clients' desires to force heirs to take money out over time, similar to the stretch IRA planning, but designated in advance by the original account owner. In the variable annuity products that I have used, I have never felt that the death benefit options were a negative feature of the annuity. Of course, each annuity should be reviewed to determine which options are available at death.

Enhanced Benefit Options

Two major categories of enhanced benefit riders—living withdrawal benefits and death benefits—might be available in variable annuities. Each insurance company has its own riders and costs, and both benefits and costs vary significantly. The following is a generic explanation of the types of benefits available. For more details on specific company options, prospective buyers should review individual companies' prospectus and summary material.

Guaranteed Living Benefits

The guaranteed living benefits offered by insurers generally have two specific features:

- A guaranteed withdrawal amount expressed as a percentage of a stated benefit amount; and
- A guaranteed increase in the stated benefit amount as long as no current withdrawals are made.

For example, an insurance company will guarantee that withdrawals beginning after age 65 will comprise at least 5% of the annual guaranteed withdrawal benefit amount (GWBA). The annual GWBA will be determined as the higher of three amounts, last year's amount plus a certain percentage (typically 5–7%), the current contract value, or some other predetermined contract value amount (e.g., the highest contract value on any day in the last 12 months, or on the monthly or quarterly anniversaries of the policy inception date). This is illustrated in *Exhibit 1*.

It is critical to note that the GWBA is separate and distinct from the contract value. If the annuity is surrendered, the owner will receive the contract value, less any surrender charges. The GWBA is only used to determine guaranteed lifetime withdrawals.

It is also important to note that taking a guaranteed withdrawal distribution is not the same as annuitizing a contract. While annuitization is an option in variable annuity contracts, it is more common to instead take distributions without annuitization.

Enhanced Death Benefit

Annuities generally have a death benefit that is equal to the amount paid into the annuity, less any withdrawals. In essence, the standard death benefit guarantees that the full amount of the premium paid to the insurance company is returned, either in the form of lifetime withdrawals or as a death benefit.

Several companies offer enhanced death benefits, whereby the death benefit is the higher of the prior anniversary date death benefit or the current contract value. *Exhibit 2* expands on the earlier example, including the death benefit with the assumed returns.

Another death benefit feature offered by certain insurers is an opportunity for two death benefits, one for the owner and another for the annuitant. This benefit works well with married couples where one spouse is the contract owner, and the other spouse is the annuitant. On the death of the annuitant, the death benefit becomes the new contract value for the owner.

When to Use Variable Annuities

The following sections describe specific planning situations in which variable annuities might be an appropriate solution.

Low-Risk Tolerance Investors

After market declines, particularly the bursting of the dot-com bubble and the 2008 financial crisis, many investors discovered that their risk tolerance was not as high as they thought. While most financial advisors were recommending a move to equities to share in potential growth after

CONSIDERATION OF ANNUITY WITH NO ENHANCED BENEFITS

Not all annuities have enhanced benefits, and those without enhanced benefits have overall expenses much lower than the enhanced benefit annuities discussed in this article. Typically, these annuities will have total costs, including investment fees, of approximately 2.1–2.6%.

These products are gaining ground, most notably for their tax deferral feature. Taxpayers face a much higher tax burden on investment income since the inception of the Net Investment Income Tax (NIIT). With general tax rate increases and the implementation of NIIT, tax rates on qualified dividends and capital gains could be as much as 58.7% higher in 2014 as compared to 2013. Taxation of interest income in that same period was possibly 24% higher.

Many insurance companies have tailored annuities to capitalize on this tax increase. In order to keep costs down on these products, there are usually no, or very few, guarantees.

these declines, many investors were so shaken by their own losses that they just could not bring themselves back into the market. The author had one retiree tell me she simply wanted her money in a savings account. A closely held business owner in his early 60s explained that he could make it to retirement with no growth, but could not afford to lose more in the market. Many younger clients scored much lower on the author's risk tolerance questionnaires than they had prior to a significant market decline.

For investors struggling with the fear of loss, but needing or preferring market upside, a variable annuity with enhanced benefits can be an important component of their overall portfolio. Once all of the negatives mentioned earlier are fully explained, the advisor should show how a variable annuity with enhanced benefits can provide the following:

- A guaranteed withdrawal account value that will have a minimum set increase greater than any savings account interest;
- A guaranteed withdrawal benefit, as a set percentage of the guaranteed withdrawal account value for life; and
- A death benefit that will effectively guarantee that the amounts deposited into the annuity will be returned during one's lifetime, or to one's heirs.

Some would say that individuals with these concerns would be better off investing in a diversified portfolio with appropriate allocations including equities, bonds, and cash. History might show that argument to be valid—except for the fact that this investor will not actually invest in that diversified portfolio out of fear of losses. The investment choice that would be made as opposed to the annuity will be an ultraconservative portfolio, perhaps all cash, and this is the investment option to which the annuity must be compared.

The author has seen his clients invest with this type of approach in the period between the dot-com bubble and the 2008 recession. An allocation of 25–50% of investable assets were placed in a variable annuity. The remaining assets were placed in a diversified portfolio, because the investor felt that the annuity's guarantees allowed them to invest in a more traditional manner. After the significant declines of 2008, many of these clients sold out their equity holdings, due to their aversion to losses, but left their annuities in place and invested as originally planned. Their annuities recovered in full from the decline, but by the time they returned to the market after the declines, they had missed too much of the recovery to have recouped all of those losses.

Investors Desiring Higher Equity Exposure with Security

Another group of investors who have made use of variable annuities are those with a desire to have a significant equity exposure. This may be due to anticipated growth opportunities, or a desire to avoid bond investments due to low current rates and fear of decline if interest rates rise. Investors with this mindset who are in a position to accept potential losses, either because their funds exceed their needs or there is a significant time frame until withdrawals are necessary, would not be candidates for a variable annuity. Their appropriate asset allocation will be a high-equity portfolio, reaping any potential rewards, and accepting the possible losses, at the reduced cost of management as compared to a variable annuity.

However, investors who are approaching retirement and have enough accumulated wealth to meet their needs, but would not be able to meet those needs if a significant market decline were to occur, should consider a variable annuity with enhanced benefits as part of their portfolio. They will still have the market upside they desire, diminished by the excess cost of the annuity over other investment options. They also gain the protection that the cash flow generated by the variable annuity will have a minimum level based on the insurer's guarantees.

The author would counsel an individual in this situation to put some of their investable assets into the variable annuity, planning that if the equity market continues positively they will withdraw from nonannuity assets to meet their needs. This allows the growth within the annuity to lock in at higher values, which will provide a higher guaranteed cash flow in the future. If the investments decrease in value, they can rely on the guaranteed withdrawals from the annuity product to meet their cash flow needs, which gives them the advantage of time to allow any losses on non-annuity assets to reverse course during an anticipated market recovery.

Investors Looking for Set Income Stream

Another client situation in which the author has recommended variable annuities is for individuals getting ready to retire who have sufficient assets to support their required cash distributions. In this situation, the author discusses a properly diversified portfolio, runs a Monte Carlo analysis, and discusses that they are likely set for retirement based on their asset base and their cash flow needs will result in a safe withdrawal rate. Sometimes these individuals talk about friends of relatives

EXHIBIT 2
Enhanced Death Benefit

Assume the same facts as in Exhibit 1, but with the addition of an enhanced death benefit:

Date	Contract Value	GWBA	Enhanced Death Benefit
April 15, 2015	$100,000	$100,000	$100,000
April 15, 2016	$110,000	$110,000	$110,000
April 15, 2017	$ 93,500	$116,600	$110,000
April 15, 2018	$102,850	$123,596	$110,000

GWBA = guaranteed withdrawal benefit amounts with defined benefit plans and lament their own lack of that guaranteed monthly check.

Purchasing a variable annuity is a way for these individuals to get that guarantee. By reviewing the terms of the annuity and understanding the client situation, the annuity can be structured to meet whatever guaranteed monthly amount they want. They will then have an insurance company–guaranteed lifetime cash flow stream that will never go down. However, unlike a defined benefit plan, there is the opportunity for the payment to go up in a positive market environment, as well as the possibility for a death benefit to their heirs.

Many of the author's clients that have bought an annuity for this purpose have structured the GWBA, combined with their Social Security payment, in order to meet their desired lifestyle. Once their cash flow needs are met, they feel a sense of freedom to be more aggressive with their remaining assets. Some have used the opportunity to invest more aggressively, and others have used that freedom to enjoy life a bit more.

Addressing Anxiety

In 2009, the author was in a meeting with a networking group of CPA financial planners. I had brought up variable annuities with enhanced benefits multiple times with this group over the years, and the response was typically that I had gone to the "dark side" of insurance sales. The argument was that a well-diversified portfolio is a better investment technique than an annuity product. But, after the market losses of 2008, my colleagues had questions about the products and their features because they were dealing with a new level of client anxiety due to the 2008 market losses, and the reality that someone retiring in 2008 (or any year with a major loss) with sufficient assets does not care that, in the long run, a well-diversified portfolio should be sufficient to meet their needs. Prospective retirees in 2008 had just seen their retirement assets drop 30% or more, and were faced with either cutting spending or going back to work. Even given an adequate long-term return, the exact timing of a market downturn can make a huge difference in terms of cash flow availability. (See an illustration of this: Allianz Life Insurance Company has demonstrated this risk with charts—available online at https://www.thecpajournal.com—both averaging 7% returns over a period of time, changing only the timing of those returns; might a variable annuity help such individuals secure peace of mind and a better retirement?) ❑

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