The High Price of Tax-Deferral: A Look at Deferred Annuities

By Peter Katt

Deferred annuities are popular because returns are tax-deferred, but if the full cycle of accumulations and distributions are considered, most purchasers would make a different choice.

Deferred annuities are remarkably popular financial assets. Individual and group premiums in 1997 totaled some $197 billion, representing about an 11% increase from the previous year and a sales surge of around 35% over a five-year period starting in 1993, according to A.M. Best's Policy Reports.

There are two basic types of deferred annuities:

- Fixed annuity premiums are deposited into the insurance company's general account, with each policy receiving the same interest rate periodically declared by the company (subject to a floor guaranteed rate). Declared interest rates will closely resemble results in each company's general account, which is primarily invested in bonds held for a yield.
- Variable annuity premiums are invested by each individual annuity owner, selecting from various mutual fund subaccounts offered by that particular insurance company.

Both types of annuities are subject to surrender charges usually starting at between 5% and 7% and generally lasting five to seven years.

Deferred annuities are popular because interest earnings or investment returns are tax-deferred. Unfortunately, annuity sellers concentrate most pre-sale information on tax-deferral and don't adequately explain or emphasize the tax consequences when distributions take place. It is my opinion that if the full cycle of accumulations and distributions is examined, most purchasers of deferred annuities would make a different choice.

Please note that, although fixed and variable deferred annuities are very dissimilar because of their investment differences, in this article I am neutral with respect to these investment differences. I have used fixed annuities as examples in this column because they are easier to explain. Also, I have used calculations that assume constant fixed-income yields in order to make certain points even though fixed-income yields are not constant.

PayOut Tax Consequences

There are a limited number of deferred annuity payout or withdrawal scenarios:

- ***Partial Withdrawals:*** Deferred annuities are taxed on an interest first basis. Therefore, an investor taking a $20,000 partial withdrawal from a deferred annuity with a cost basis of $100,000 and a current value of $120,000 will report the full $20,000 as income. In addition, if the investor is not yet 59½, the partial withdrawal is subject to a 10% penalty tax. Finally, a partial withdrawal may be subject to surrender charges.
- ***Policy Surrenders:*** Complete surrenders are subject to income taxation on the gain plus the penalty tax if done before age 59½. In addition, if the policy termination has occurred during the surrender charge period, the insurance company will impose surrender charges.
- ***Payout Due to Annuitant's Death:*** All of the gain is subject to income taxes, but no penalty taxes or surrender charges apply.
- ***Exchange of Deferred Annuity for an Immediate Annuity:*** An immediate annuity pays the policy owner income until death, usually monthly. A portion of each payment, depending on the annuitant's age, is a tax-free return of cost basis and a portion is taxable as interest. This combination (deferred then immediate annuity) is a very tax-effective way of providing retirement income. But, a life-only immediate annuity's principal is lost upon death even if death were to occur only days after its purchase. At additional cost a specified number of payments, usually for 10 years, can be guaranteed

even if the annuitant were to die within the specified time period. In either case, the goal is to maximize retirement income for the annuitant, and not to provide an inheritance for heirs.

As the preceding annuity tax rules suggest, forethought about possible uses of a deferred annuity is needed.

Annuity Planning

For the purpose of discussing deferred annuity planning, it is useful to identify three distinct financial groups.

20-, 30-, and 40-Something Investors: Generally, this is a time for raising families while struggling to accumulate wealth in a form that is marketable or liquid enough to respond quickly to business opportunities and expected and unexpected family costs. As such, deferred annuities, because of adverse tax consequences associated with partial withdrawals for premature surrenders, are generally a very poor choice for this group. However, this doesn't mean that attaining tax-deferred savings or investing can't be achieved beyond qualified retirement plans, such as 401(k) plans. Most 20-, 30-, and 40-something families need sizable amounts of life insurance for family protection purposes. A designated portion of the needed life insurance can be purchased using low-load universal life or variable universal life and super-funding such policies so that beyond the term insurance costs (which would be incurred for term insurance anyway), excess premiums earn interest at the insurance company's declared rate (for universal life) or investment returns from mutual fund sub-accounts selected by the policy-owner (variable universal life). The universal or variable universal life's cash values accumulate similar to deferred annuities, but withdrawals are tax-free until the policy's cost basis has been withdrawn. An investor whose policy has a $100,000 cost basis and current value of $120,000 could withdraw up to $100,000 tax-free. And these policies can be used very nicely to provide supplemental retirement income as well. (See my November 1995 *AAII Journal* column, "The Life Cycle of Insurance Needs: A 30-Something Example," for a complete explanation of the concept of using super-funded universal or variable universal life for the dual purposes of providing family protection life insurance and tax-deferred asset accumulation.)

Investors in their 20s, 30s, and 40s who don't need life insurance for family protection should still avoid deferred annuities until it is clear that there is very little chance such funds would be liquidated for possible business opportunities or other needs. When it is clear that investments will not be needed for anything other than retirement income and the investor has no interest in providing some or all of the investment principal to heirs, the combination of a deferred annuity with an exchange to an immediate annuity would be ideal.

50- and 60-Something Investors: Generally, investors in this group have lighter financial responsibilities and rising incomes. For many the most significant asset accumulation period begins in their 50s. But it is also during this period that income taxes will become more onerous because the family's income is up while the number of dependents is down. Therefore, tax-deferred investing becomes even more relevant. The desire for tax-deferred investing during the final push to retirement will naturally cause investors to think of deferred annuities. The problem of unexpected partial withdrawals or premature surrenders that is of concern for younger investors has probably largely dissipated for the 50- and 60-something group. But now more attention is paid to planning for the distribution of accumulated assets to heirs, and it is this area that causes deferred annuities to be less attractive.

There are three likely scenarios with respect to late-term investing for this group. One scenario is for the investor to plan that all of the accumulated funds will be distributed to heirs because retirement income has already been secured. A second scenario is to use the income that can be generated from these accumulated late-term investments, but target the principal to heirs. A final scenario is to use the entire accumulated amount in retirement without any held back for heirs. Of these three scenarios, only the third favors using deferred annuities.

Scenario one, distributing late-term investments to heirs, is very much at odds with investing in deferred annuities held until death because their entire gain is subject to income taxes. Clearly, if this is the goal, life insurance is preferable because its proceeds are not subject to income taxes. Also, investors who don't need late-term investments for their own retirement are probably facing estate taxes, so considerations should be given to having these late-term investments (life insurance or otherwise) owned outside their estate to avoid an increase in estate taxes.

The second scenario, using only income generated from late-term investing with the principal distributed to heirs, is at odds with the combination use of deferred and immediate annuities because all of the principal is used up upon the annuitant's death. For example, a 55-year-old male investing $25,000 a year to age 65, with the goal of taking income only, might use a strategy of investing in bonds (to be consistent with a comparison with fixed deferred and immediate annuities) with interest reinvested. Assuming yields of 7.5%, principal of some $320,000 might be accumulated at age 65, with income of some $24,000 (about $15,000 after-tax) available for life in retirement without touching the principal. Upon death, his heirs would inherit $320,000.

The third scenario of late-term investing with the goal of using all of it during retirement is ideal for the combination of deferred and then the immediate annuities. From the preceding example, a 55-year-old male investing $25,000 a year to age 65 in deferred annuities could exchange them for an immediate annuity and receive guaranteed income of some $29,000, 60% of which would be considered a return of principal. This scenario would provide about $24,000 in after-tax income for life.

You probably noticed that the annuity approach (scenario three) provides about $9,000 more after-tax income than available from scenario two. This might lead investors to get fancy and go the annuity route for scenario two and either buy life insurance or create a side fund to meet their goal of distributing the principal to heirs. I tried this combination approach and it isn't likely to work.

70- and 80-Something Investors: Individuals within this group may be continuing to invest (which can be either restructuring existing assets or new investments) or they may be in search of income from investments. Clearly, immediate annuities can be considered for this task for individuals who aren't concerned that the principal used to purchase the immediate annuity will usually be consumed during their lifetime leaving no principal to be inherited by heirs. But immediate annuities should only be purchased by individuals in excellent health, because their value depends on how long the annuitant lives, and they therefore favor the very healthy who will predictably live longer than average. This is true because insurance companies don't consider health when selling immediate annuities, therefore all purchasers of the same age and sex get the same amount of annuity income. Unhealthy buyers of immediate annuities will predictably get far less in total payments than heal thy buyers. However, the insurance companies' practice of ignoring the health of immediate annuity purchasers could change.

Individuals in their 70s and 80s who are restructuring or adding new investments for the sole benefit of their heirs and who are in at least fair health should avoid deferred annuities and purchase low-load universal life because the life insurance proceeds are income tax-free whereas the deferred annuity's gains are fully taxable. For example, a 75-year-old male investor able to qualify for a rather modest Table D substandard universal life rating with minimum initial death benefits relative to the single premium paid will produce 18% (in five years) to 26% (in 20 years) better benefits than the after-tax value of a deferred annuity. Even an investor in rather poor health who can only qualify for an insurance company's worse substandard rating can achieve 10% to 15% better results compared with the deferred annuity. Only investors who can't qualify for life insurance at all should consider a deferred annuity to at least defer taxes.

At the risk of being overly complicated, here's a word about 70- and 80-something investors seeking equity investments. If you are in this category and can qualify for life insurance, a low-load variable universal life with minimal initial death benefits will be ideal because the investment strategy can be changed without exposing the change in investment subaccounts to taxes on gains and the proceeds are income tax-free at death. However, if life insurance isn't available, investing directly in equities (or via a mutual fund) will work much better than a deferred variable annuity because the stocks held in the investor's name will get a step-up in basis at death, eliminating income taxes on gains, which isn't the case with a deferred variable annuity, whose gains are taxable. (Note, however, that if the stocks are owned by an irrevocable trust, there is no step-up in cost basis.)

Finally, 70- and 80-something investors in at least fair health who have already purchased deferred annuities without realizing that the gains would be fully subject to income taxes at their demise can do some creative planning and dramatically improve results for their heirs. The following case study explains how to unwind an existing deferred annuity.

Jerry Nelson, 70 and in good health, acquired a deferred annuity 13 years ago with a single payment of $200,000 that has a current value of $500,000. It is currently earning 5.75%, so if he lives to life expectancy, around 88, the expected value of his deferred annuity would be $1.37 million, subject to income taxes of some $467,000, for a net value of $903,000. His wife, Marilyn, is also 70 and in excellent health. Their net worth is $4.0 million, so they have estate tax concerns. They can't surrender the annuity because this would trigger income taxes, nor does tax law permit a tax-free exchange to a life insurance policy. So Jerry and Marilyn applied for a low-load second-to-die universal life policy with minimal increasing death benefits, owned by and payable to an irrevocable trust. This policy was issued with standard ratings. They then exchanged the deferred annuity for an immediate annuity paying after-tax income of $31,100 for their joint lives. Jerry and Marilyn gift the net annual annuity payments o f $31,000 to the trust, which pays the life insurance premiums. Using the same assumed interest rate, I calculate that the net value to their heirs for the immediate annuity/life insurance is 20% to 40% greater than retaining the deferred annuity, depending on when the second death occurs. In addition, unlike the deferred annuity, the life insurance proceeds are not in their estates because the policy is owned by an irrevocable trust, producing even greater value for their heirs. For example, by age 90 the value of the immediate annuity/second-to-die universal life policies is projected to be some $1.3 million compared with the projected after-income-tax value of the deferred annuity of $1.0 million, and the life insurance proceeds are not subject to estate taxes.

Conclusion

While deferred annuities are worthwhile investments, they are too often purchased without full consideration given to consequences of partial and full surrenders, which suffer from adverse tax rules and insurance-company-imposed penalties. Further, when deferred annuities are held until death, all of the gain is subject to income taxes, which can be avoided by instead purchasing other assets.

With a bit more foresight, investors can better select investments, including deferred annuities, that are well-matched to their family and financial conditions and to the goals they are trying to achieve.

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