

Photo Finish

When it comes to after-tax distributions, separate accounts edge out variable annuities by a length in the capital-accumulation race

William H. McAfee Jr.

A COLLEAGUE CALLED me recently to get my input on an investment decision he was helping a client make. The client had sold some real estate for about \$500,000 and was looking to invest the cash for a period of 10 to 20 years with the purpose of capital accumulation. My colleague was

particularly interested in variable annuities because of the tax-deferred accumulation they offer and because he believes they're a relatively easy investment to manage. He also was considering separate-account management, especially given the amount of the investment, but he was leaning toward annuities because he saw the tax-deferred growth as an overriding advantage.

I pointed out that by choosing an annuity over a separate account, he was taking future gains that could potentially be subject to capital-gains tax treatment and subjecting them instead to ordinary income tax treatment.

We agreed that the key questions were as follows: Does an annuity's tax-deferred accumulation advantage outweigh the treatment of its earnings as ordinary income at distribution? And, would a client who invested in tax-



efficient separate accounts and paid capital-gains tax on earnings ultimately generate more capital than he would with an annuity after taking distributions? These questions became more intriguing with the May passage of the Jobs Growth and Tax Relief Reconciliation Act of 2003, which reduced the

maximum tax rate on both long-term capital gains and dividend income to 15 percent.

To get some answers, we designed a "horse race" between the two investment options. For the race, we assumed an 8 percent annual growth rate for each account, and assigned an income tax rate of 35 percent, which mirrored the client's circumstances. Each account was also assigned a dividend rate of 1 percent, and the separate account's dividend income was taxed at a rate of 15 percent. (Originally, we ran the test using the 36 percent rate and updated it to account for the new legislation.) To show the effect of trading, we also assumed a 20 percent annual turnover rate for the separate-account portfolio. Again, the gains from this activity were subjected to a long-term capital-gains tax rate of 15 percent. No distributions were taken during the hypothetical 10-year period for which we ran the scenario.

We started the race with \$500,000 in each account. The annuity took an early lead, finishing year one with a balance of \$545,000, compared with the separate account's balance of \$543,050. That margin widened, as the annuity

William H. McAfee Jr., CFP, is a managing director of Kent Evan Group, a consulting firm in Greenville, S.C., that develops capital-growth and -preservation strategies for business owners.



Conclusions we can draw from our test: the tax-deferred accumulation feature of annuities is overrated, and separate accounts offer investors considerably more flexibility

gained more ground each year. By the beginning of year 10, the annuity had a significant lead, with a balance of \$1,085,947, compared with \$1,051,473 for the separate account. Many investors would be pleased with either horse's results, since both more than doubled the original balance. But we were determined to crown a winner.

Any wise investor knows, it's not what you make, but what you keep that matters. So we added a final step: we distributed the proceeds from each account and assessed all taxes—the financial equivalent of the after-race drug test. When the annuity earnings of \$585,947 were taxed at the rate of 35 percent, the total value of available distributions was \$880,865. When the separate-account earnings of \$551,473 (that is, earnings not already taxed as realized gains from turnover) were subjected to a 15 percent capital-gains rate, the total balance available to the client was

\$968,752. The separate account, in other words, had generated an after-tax balance 9.98 percent greater than the annuity for the 10-year period. Interestingly, even under the old tax-law structure—with dividends fully taxable at ordinary income tax rates, and the capital-gains rate at 20 percent—the after-tax value of the separate account was still higher than the annuity's, by 5.84 percent, for the period.

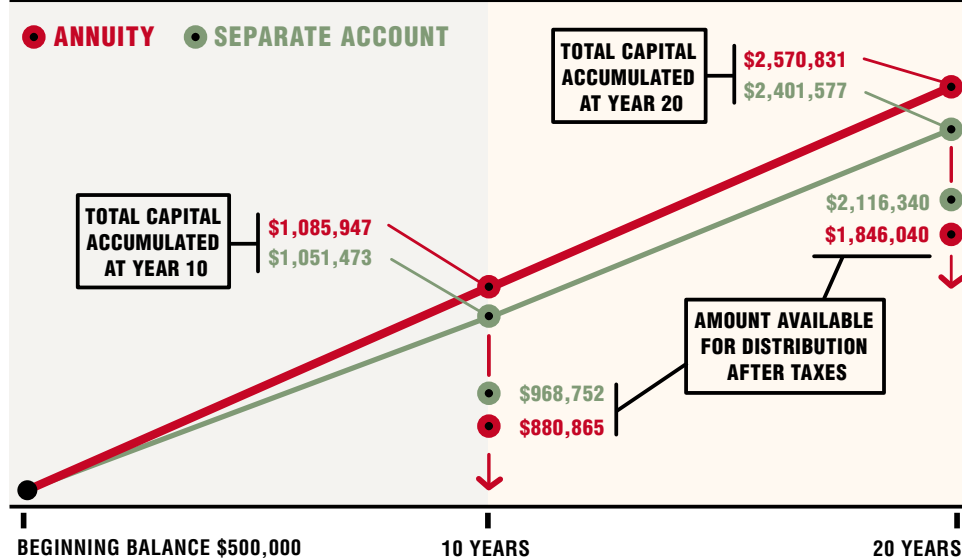
To see whether the benefit of tax deferral would win out over a longer period, we ran the model a second time and changed the distribution date to year 20. Again, the annuity built a healthy lead during the accumulation period. After accounting for ordinary income tax of 35 percent on the annuity earnings of \$2,070,831 and 15 percent capital-gains tax on the separate-account earnings of \$1,901,577 not yet recognized through annual turnover, the after-tax balances were \$1,846,040 and \$2,116,340, respectively.

With the additional 10 years of accumulation, the separate account accumulated an after-tax balance 14.64 percent higher than the annuity's.

To approximate real-life conditions, we also measured the effect of fees, using the average difference in fee structure between variable annuities and separate accounts as measured by the Morningstar Principia database. As of November 30, 2002, the average fees for variable annuity products covered by Morningstar was about 2.22 percent per year, whereas the average fee for separate accounts in the size range of our test was about 1.50 percent. This adjustment substantially affected our results. When fees were considered, the separate account generated an after-tax balance 13.44 percent higher than the annuity at the 10-year distribution point and 18.12 percent higher at the 20-year distribution point. Annuities have another potential disadvantage: most include surrender charges, which as of November 30, 2002, averaged about 5.62 percent for withdrawals during the first five years for variable annuities tracked by Morningstar Principia. We did not, however, account for surrender charges because, for our test, all distributions were taken at year 10 or later.

Our model also did not account for a couple of other factors. If the annuity owner in our example recognized his entire 10-year earnings of \$585,947 in one year, for instance, his deductions would be phased out beginning at \$112,000 in ordinary income. Of course, investors could spread payment over a number of years to lower their effective tax rate, but to get this rate below the capital-gains rate of 15 percent, they would have to employ a long-term strategy, taking very small withdrawals and annuity payments—that is, they could not raise taxable income for an individual above \$28,400 or for a married couple above \$56,800. Interestingly, the separate-account owner could continue to defer capital-gains tax as well, by deferring the liquidation of his assets, and potentially

NOT OVER TILL IT'S OVER



During the accumulation phase, a \$500,000 investment in a variable annuity steadily outperforms a comparable investment in a separate account. But when the capital is distributed and taxes paid at the end of 10 or 20 years, an investor in a separate account comes out ahead.

could avoid tax on the gain altogether by holding the assets until death, at which time his heirs would receive a step-up in cost basis to the date-of-death value. The annuity offers no such tax-avoidance option, however, because the annuity earnings become taxable as income to the beneficiary at death.

Two other points on tax assumptions: First, we did not measure or account for the effects of state taxes. Second, we assumed the annuity owner was older than 59½ because annuity owners can't take any distributions until then without incurring a 10 percent tax penalty.

In regard to the separate-accounts portfolio, the turnover rate is a key driver in the process: if turnover is too frequent, the separate account underperforms the annuity. We ran our scenarios with increasing levels of portfolio turnover, and the separate account continued to outperform the annuity until the turnover rate reached 131 percent per year. At that point, the separate account generated an after-tax distribution balance of \$874,807 compared with the annuity's after-tax distribution balance of \$875,006. In other words, the separate account underperforms the annuity if its average holding period is equal to or less than 0.76 years, or 9.16 months. However, because an annual turnover rate of 131 percent guarantees that some of the gains will be short term, and therefore taxable as ordinary income, practically speaking, the separate account will underperform the annuity anytime

turnover exceeds 100 percent annually.

From our test, we can draw several conclusions that have practical implications. First, the tax-deferred accumulation aspect of an annuity is overrated as an attraction for investors interested in accumulation of capital over a long time horizon. The new tax legislation has magnified this point. Second, although annuities are advertised as accumulation vehicles, they are much more effective as distribution vehicles. That is, the original intent of annuities as a vehicle for the client to avoid outliving his principal makes sense. However,

when using variable annuities as a distribution vehicle, you must tightly control the timing of distributions for the annuity to be more tax effective than other investment assets. Third, separate accounts offer considerably more flexibility in timing of recognition of gains and the liquidity of assets. The separate account may cost the client less in fees as well, which as our model shows, can make a substantial difference in real return. But, in order for separate accounts to be more effective for tax efficiency, the adviser must keep the portfolio turnover reasonably low.

Clients already holding variable annuities may be able to avoid a massive tax bill by taking advantage of the often overlooked Section 72(t) of the Internal Revenue Code, which permits early withdrawals from annuities penalty-free as long as they're taken in substantially equal periodic payments no less frequently than annually. Some clients may be better off taking equal payments from their annuities today and moving them to a separate-account portfolio, thus avoiding the taxation of annuity earnings as ordinary income in retirement or at final distribution. You should discuss this option with clients to determine its suitability and alignment with the client's long-term objectives.

In light of the recent tax-law changes, careful analysis has become crucial for clients thinking of entering into variable-annuity contracts. For the client whose primary concern is tax-efficient accumulation of wealth, a separate-account portfolio may be the better option.

WM