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Variable Annuities #1: Tax Deferral Can Make You Poorer!

Introduction

Tax-deferred variable annuities are contracts with insurance companies through which the public can invest in portfolios of stocks and bonds called sub-accounts. These annuities are costly, complex investments sold in part because of a misunderstood tax deferral feature that often leaves investors with less after tax wealth.

Taxes on returns to investments in an annuity are deferred; income and capital gains accumulate in the sub-accounts without being taxed until withdrawals are made.

Tax Deferral Can be Beneficial

Deferring taxes can increase an investor's future after-tax wealth. For example, a $1,000 investment that increases 12% each year will be worth $3,106 in 10 years. If the $2,106 gain is taxed at 40%, the investor will be left with $2,264. If the 40% tax rate had been applied each year to the returns earned that year, the investment would have been worth only $2,004.

Our example is incomplete because taxation of investment returns depends on whether the returns are distributed as dividends and interest or as capital gains. Some dividends and interest coupons are treated as ordinary income and are taxed at marginal income tax rates. Capital gains on the other hand are not taxed until they are realized by a sale of the investment and the tax rate applied depends on how long the investor has owned the investment.

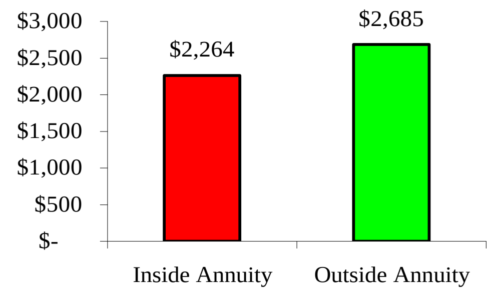
Taxes Are Higher on Annuities' Returns

The returns to an annuity are not taxed prior to the start of scheduled withdrawals. When the withdrawals begin, the returns accumulated within the annuity are taxed as current income rather than at the lower capital gains tax rate, even if the returns are entirely capital gains.

It is possible - even likely - that investors buying annuities will actually end up paying more in taxes and having less after-tax wealth at retirement, because of the *harm* caused by the tax *benefit* claimed for tax-deferred annuities.[1]

Modifying our simple example to include taxation of long-term capital gains at 20%, investors are much better off accumulating returns outside the annuity so long as at least $^{2}/_{3}$rds of the total return is from capital gains.

For instance, if 2% of the 12% annual return is interest income and 10% is capital gains which can be left unrealized in a taxable account, in 10 years an investor will have $2,513 in a taxable account after taxes but only $2,264 after taxes in the annuity. If the annuity sub-accounts hold only equities, an investor would have $2,685 after taxes in a taxable account but only $2,264 after taxes from investing in an annuity.



Conclusion

The tax deferral feature of annuities *harms* investors who hold mostly equities in their sub-accounts. If these investors are not told that they are being tax-disadvantaged by this tax deferral feature, then their brokers are making material misrepresentations and omissions.

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[1] The relative after-tax returns from annuities are even worse in comparison to private accounts and taxable mutual funds when the option to harvest losses is considered.

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