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PDV *OBSERVATIONS*

Variable Annuities

Several PDV clients recently sought our advice regarding the attractiveness of variable annuities ("VA's"). Because of this interest, we have decided to address this topic in this issue of ***Observations***. This article is primarily a reprint of a two-part piece that we wrote in ***Observations*** a few years back, but it has been updated to conform to the provisions of the newly enacted tax-reduction legislation.

Variable annuities have become very popular in recent years. Any time a financial product gains a wide following, a contrarian question to ask is whether such popularity is well deserved or just the result of hype and salesmanship.

In this article, we will examine the basics and benefits regarding VA's. We will then explore the disadvantages of investing in VA's and suggest ways to critically evaluate these financial products.

VA's are insurance products with an investment component. When you buy a VA, you are entering into a contract with an insurance company. You pay certain premiums, a portion of which is retained by the insurance company for its benefit. The remainder is invested at your discretion among what are commonly known as "subaccounts", which are essentially mutual funds set up specifically for the VA's. These mutual funds are very similar to their counterparts offered by the same mutual fund companies outside of the VA area.

You have the option to select the maturity date (also known as "annuity date") of the contract, at which time you have various options to have the value of the VA paid to you and other beneficiaries. During the period prior to the annuity date (known as the accumulation phase), the premiums you pay (less any amounts deducted by the insurance company) are invested in the subaccounts. Whether the invested amounts will grow depends on the performance of the underlying mutual funds.

The money invested in the subaccounts is segregated from the assets of the insurance company and not subject to the claims of its creditors. The financial condition of the insurance company underwriting the VA is therefore less important, since its failure should not result in the loss of whatever value has been built up in the subaccounts (though the financial failure of the insurance

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company could adversely impact its ability to pay the death benefit (described below).

While the specific requirements and benefits will differ among VA's, as a generalization there are certain common benefits that all VA's offer. **The most important benefit is that any returns derived from investment in the underlying mutual funds are *not* taxed until the amounts are withdrawn.** This means all income and capital gains accumulate on a tax-deferred basis, and you can switch between mutual funds in the subaccounts without triggering any taxes. However, the value of this tax deferral will be diminished by the recent tax legislation that reduces the tax rates across the board applicable to ordinary income and short-term capital gains.

Before you run out and buy a variable annuity, you need to be aware that variable annuities often involve costs and expenses that overwhelm the benefits promoted by those selling variable annuities.

Further, while some VA's restrict the amount you can invest in the subaccounts, the **restrictions are usually considerably more liberal than those relating to 401(k) plans, profit-sharing plans, Keogh's and IRA's.** Therefore you are generally able, through the use of VA's, to shelter more of your money from taxes.

Also, unlike IRA's (which currently mandate distributions to commence after the account holder turns 70 1/2 years old), many **VA's allow you to leave your money in the subaccounts accumulating tax-deferred for a longer time without being required to withdraw it.**

Moreover, the insurance company will pay a death benefit if you die during the accumulation phase. The death benefit is *not* the same as life insurance, and usually equals the greater of the amount you have invested (less withdrawals and any applicable premium taxes) or the aggregate value of your subaccounts.

While the benefits described above are of unquestionable value, you need to weigh the disadvantages of VA's against their advantages. Unfortunately, as VA's are very lucrative for those selling them, these disadvantages are often not adequately discussed with the prospective VA buyer.

Before you run out and buy a VA, you need to be aware that VA's often involve costs and expenses that overwhelm the benefits promoted by those selling VA's. Also, while one of the biggest benefits of VA's lies in their tax-deferred feature, VA's ironically also produce some *adverse* tax consequences.

For instance, in exchange for tax deferral, the insurance company underwriting the VA typically takes a sizable percentage of your funds off the top before allowing you to invest in the underlying mutual funds. Essentially you are paying (often dearly) for the tax-deferral feature.

If your funds are already in a tax-deferred account such as a 401(k), SEP-IRA, IRA or Keogh account, it makes no sense to have the broker or insurance agent convince you to buy a VA with the funds in the account. After all, why pay for something (tax-deferral) that you already enjoy? While tax-deferral is not the only advantage offered by VA's, the other benefits (such as the death benefit) are generally not worth the high costs associated with VA's.

Unfortunately, here at PDV we have repeatedly seen overzealous brokers and insurance agents put investors' funds in tax-deferred accounts into VA's. Several PDV clients were victims of this type of unethical behavior, before they came to us for advice.

If you have discretionary income, you should take full advantage of the tax-deferred retirement accounts by putting your savings (often on a pre-tax basis) first into these accounts up to their investment limits. The good news is that the new tax legislation recently enacted by Congress will increase these limits over time.

With respect to any discretionary funds that cannot be put into retirement plans because plan limits have been reached, the question is whether to buy tax-deferral by investing in a VA, or to invest the money on a taxable basis outside of a VA. Tax-deferral is only desirable if it can be obtained at an acceptable cost.

The typical VA has annual fees of about 2% (in addition to possible annual contract, administrative and service fees), which are considerably higher than the average operating expense level of a typical mutual fund held outside a VA. The discrepancy is generally not adequately justified by the insurance benefits offered by the VA. Added to these recurring charges are often front-end or back-end sales charges (similar to those levied by load-funds). These onerous charges are to compensate the people selling VA's, giving them incentive to emphasize the positives about VA's and gloss or skip over the negatives.

If your funds are already in a tax-deferred account such as a 401(k), SEP-IRA, IRA or Keogh account, it makes no sense to have the broker or insurance agent convince you to buy a VA with the funds in the account.

To critically evaluate a VA, you need to have some idea how long it will take the benefits from the compounding effect of the tax-deferred returns to outweigh the annual drag of the costs and expenses on your returns.

Even if your evaluation concludes that the tax-deferral benefits will overwhelm the extra costs and expenses within an acceptable time period, there are other *adverse* tax consequences to consider.

First, while long-term capital gains from mutual funds outside a VA would be taxed at capital gain rates (currently 20%), such capital gains in

the underlying mutual funds of a VA are taxed at ordinary income rates when withdrawn (which can run as high as 39.6% currently, though this is scheduled to drop somewhat because of the new tax legislation).

Second, if you decide you want to access the funds in the VA before 59 1/2, except in limited circumstances, you will have to pay a 10% penalty. Since a VA locks you in a limited number of pre-selected mutual funds, underperformance of the underlying funds will leave you in a quandary of whether to continue tolerating mediocre performance or switch to other more promising investments and get hit with the adverse tax consequences.

Third, while mutual funds held outside a VA get a stepped-up income tax basis at your death so that your heirs are sheltered from income tax on the unrealized capital gain built up during your lifetime, your heirs will be taxed on all the gain in your VA upon your death.

Like many other financial products, VA's are not categorically good or bad. There are some VA's that offer more attractive features than others, and you need to be selective. Even the better VA products may not be appropriate for you. Ultimately, your investment objectives and time frame, as well as your tax situation will determine whether VA's might be of benefit to you.

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