A VALUABLE BENEFIT OF ANNUITIES: TAX DEFERRED GROWTH

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Annuities can be viewed as an account type that changes the tax rules applied to investment growth. Similar to other basis assets such as funds taxed on long-term capital gains, annuities allow an investor to protect annual gains from taxation until the sale or distribution of funds from the account. Unlike long-term capital gain assets, annuity distributions are taxed at ordinary income rates. This makes annuities relatively more attractive for housing investments whose gains are subject to annual taxation on growth, and particularly attractive for investors who expect their marginal income tax rate to decline in retirement.

The increasing availability of low-cost variable annuity wrappers, as well as highly competitive guaranteed returns on fixed multi-year guaranteed annuities (MYGAs)[1] and attractive lifetime withdrawal benefits on fixed annuities, provides investors with a range of competitive products that should be considered as alternative to holding bond-like assets in taxable accounts. If the primary goal of non-qualified fixed income investments is to fund less variable spending in retirement, then annuities can provide a higher after-tax return in addition to their unique benefit of protecting against longevity risk.

Since annuities are considered a tax-advantaged retirement saving instrument, early withdrawals are subject to a 10% penalty if withdrawn before age 59.5, and there may be surrender charges that increase the cost of early distributions. Reduced short-term liquidity should be weighed against the potential increase in after-tax spending that can be achieved through the annuity.

NET RETURNS AND ANNUITIES

Net (or after-tax) returns on growth on an asset are the portion of returns that can be spent by an investor. The net return on assets whose growth is taxed annually, such as CDs, is simply the gross return multiplied by 1 minus the tax rate. For example, a 5% return taxed at a combined 30% state and Federal income tax rate will provide a net return of 3.5%. In this analysis let's ignore the possibility of long-term gains in bond investments and focus on annually-taxable yield.

Annuities provide two forms of potential tax-advantaged growth. First, annuities benefit from the compounding of unrealized gains. This benefit of basis taxation increases the net return each year that the basis is allowed to grow free of annual taxes. The longer the gains remain untouched, the higher the net return difference between annually taxable assets and annuities.

1. https://www.advisorperspectives.com/articles/2020/10/12/guaranteed-returns-in-a-low-yield-environment

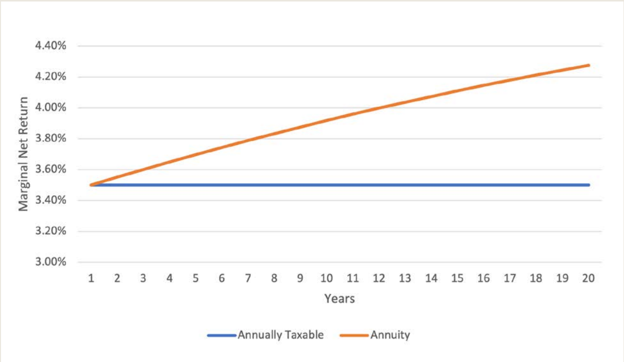
Consider the following example. A 57-year old investor is considering funding basic expenses in retirement using either a CD (or highly-rated corporate bond) that provides a 5% annual return. Over the next 10 years, she will receive 3.5% annual net returns if her marginal income tax rate is 30% (22% Federal, 8% state). After 10 years, an initial $100,000 will grow to $141,060.

If she instead either invests in bonds within a variable annuity wrapper, or simply buys a multi-year guaranteed annuity (MYGA) earning 5%, her annuity value will grow to $162,889. If she is still in the 30% marginal tax rate and withdraws her gains fully at age 65, her after-tax investment value will be $144,023. She achieved an extra 22 basis points by investing in a MYGA instead of a CD.

The net return difference between annually-taxable assets and annuities increases each year. If she simply sold her MYGA after 5 years, she would have received only a 10bp/year tax benefit. If she sold after 11 years instead of 10 years, her after-tax net proceeds at a 30% income tax rate would be $149,724 instead of $144,023. Her net return during the 10th year of investment is 3.96%. Her net return during her 20th year of investment would be 4.30%. The longer she allows her gains to compound free of taxes, the greater her net return from holding assets within the annuity.

The increase in annual net returns when interest rates are 5% is shown in Figure 1.

FIGURE 1. *Marginal Net Returns from Annually Taxable Asset Earning 5% at 30% MTR*



After the 20th year, at 5% gross return the original investment of $100,000 will provide $23,213 more retirement spending when held within an annuity rather than in an annually-taxable investment such as a CD or bond. Annuities provide a greater increase in retirement spending when assets are held for a longer period of time, or when interest rates are higher. For example, at a 6% gross return the difference in retirement spending between an annually taxable investment and an annuity after 20 years increases to $40,274.

TAKING GAINS IN A LOWER TAX RATE ENVIRONMENT

More dramatic improvements in retirement spending can be achieved if the investor accumulates non-qualified wealth during a period of higher marginal tax rates and draws from an annuity during periods of lower marginal tax rates. For example, a high-earning investor who does not expect to receive a pension may be in a significantly lower marginal tax bracket during retirement. She can achieve growth within the annuity free of high taxation on gains during her working years and distribute a higher after-tax amount after retirement in a lower tax environment.

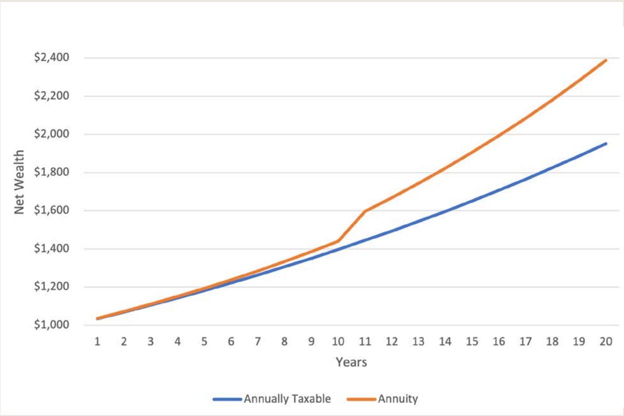
If the 57-year old investor finds herself in a 12% Federal and 4% state tax bracket at age 67, how will this affect her net returns from holding annually taxable assets within an annuity? For the first 10 years, her annually taxable bond/CD investments would still earn a 3.5% net return, and her 5% annuity would continue to grow untaxed until distribution.

If she distributes the annuity in her 10th year in a 16% marginal tax bracket, her $100,000 will have again grown to $162,889. The $62,889 in gains will be taxed at a 16% marginal tax rate (assuming they do not push her into a higher tax bracket), resulting in a net annual return of 4.33%, or an 83bp improvement over holding the investments in annually taxable assets in a higher tax bracket.

If she remains in a 16% tax bracket, the net return on annually taxable CDs/bonds will rise to 4.2% after retirement. However, the net return during the decade prior to retirement was 3.5%, resulting in significantly less wealth available to fund retirement expenses. In addition, the net return from waiting from year 10 to year 11 to withdraw from the annuity will be 4.48%. As the time horizon increases between the initial investment and the withdrawal of funds from the annuity, the difference between the net return of an annually taxable asset and the same asset held within an annuity will grow each year.

Figure 2 illustrates the total wealth available to the retiree over time from assets held within an annuity compared to annually taxable assets when the investor's marginal tax rate falls from 30% to 16% in retirement.

FIGURE 2. *Impact of a Decrease in Retirement Marginal Tax Rate (30% to 16%) on Net Wealth*



After 20 years, an initial investment of $100,000 provides $238,877 of total retirement spending when held within the annuity compared to $195,169 when held within an annually-taxable investment earning the same 5% gross return. This represents a cumulative 22.4% increase in potential spending after 20 years.

The flexibility in deciding when to withdraw assets from an annuity in retirement allows an investor to manage taxable income to remain within more favorable tax brackets in order to maximize net wealth available to spend. Annuities that levy an expense to cover the cost of providing a lifetime withdrawal benefit may be able to surmount a significant portion (if not all depending on the insurance cost and tax bracket of the investor) of the cost of insuring against the risk of outliving savings.

SUMMARY

Holding assets inside an annuity structure allows an investor to defer taxation of investment growth. The benefit of deferred taxation rises with holding period and interest rates since untaxed gains held within an annuity are allowed to compound over time. An annuity can provide significantly higher wealth if used to defer assets from taxation during working years when an investor would otherwise be taxed on gains at a higher rate.

The bottom-line? An investor who strategically withdraws savings from an annuity after retirement can spend significantly more than an investor who holds annually taxable investments such as bonds, CDs, or high yield savings accounts.