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Variable Annuities for Tax-Efficient Growth

Variable annuities can help accumulate assets for retirement with tax-deferred growth, flexible, tax-free reallocations, and death benefits for heirs.

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When choosing an annuity contract, investors must first determine their primary objective—growth of assets or income in retirement. This is particularly true for variable annuities, which carry some restrictions and limitations when used to generate income. As tax-deferred annuity contracts designed for the long term, variable annuities offer the contract owner the opportunity to participate in the performance of an underlying portfolio of funds.

In this article, we'll explore key benefits and considerations of a variable annuity as a tax-efficient accumulation strategy, focused on delivering choice, flexibility, and protection for heirs.

Choice: diverse investment funds in a tax-deferred package

Every variable annuity offers choice and diversity–a single variable annuity could offer over 100 different fund options from 15 or more different investment managers, with exposure to asset classes like real estate, commodities, and alternative investments. This variety allows investors to build a portfolio aligned with their risk tolerance and objectives.

Tax deferral is a second key benefit to owning a variable annuity. Like every annuity, investors don't pay tax on any growth in their account value until they make a withdrawal. Tax deferral in a variable annuity is an important feature for those trying to accumulate money for retirement. Since the taxes are deferred, investors earn interest on:

- their original investment,
- their earnings,
- and the money they would have paid in taxes each year.

Eventually, ordinary income taxes will have to be paid on any gains withdrawn from the account but until that time comes, an investor's money can grow more efficiently. It is important to note if a variable annuity is owned within a qualified retirement plan, such as an IRA, the annuity carries no additional tax benefits as the IRA itself is tax-deferred.

Flexibility: reallocations are not taxable events

As investors save money for retirement, over the years their investment objectives could change and their view of the market and risk appetite may shift. A variable annuity allows flexibility to reallocate money from one fund to another within the same contract, rather than sell one investment to buy another. A reallocation within the annuity does not create a taxable event, given no taxes are due until gains are withdrawn from the contract.

This is not the case with more traditional investments—if an investor sells a mutual fund, stock, or bond to allocate to a new investment, gains will be taxed. Some investors may even hold onto an asset they would prefer to sell to avoid the capital gains tax.

Protection: for heirs, against a premature death

Most variable annuities include or offer a death benefit within the annuity contract for a fee. This benefit is designed to generate a payment to any designated beneficiaries upon the death of the annuity contract owner, so long as the death occurs prior to annuitization of the contract. As additional protection, this benefit ensures that when a contract owner dies, the designated beneficiary(ies) is guaranteed to receive no less than the premium invested.

As an example, let's say an investor bought a variable annuity and a stock mutual fund shortly before the COVID-19 global pandemic. In five short weeks during February and March of 2020, the S&P 500 Index fell ~30%.[1] If the contract owner had died during this time, the designated beneficiary(ies) of the variable annuity contract with a death benefit would receive the investor's premium investment, adjusted for any previous withdrawals.

On the other hand, the person receiving the mutual fund investment would get the value of the investment on the day of the investor's death, which could be higher or lower than the initial investment. This "return of premium" death benefit within most variable annuities is particularly attractive to investors when estate planning becomes a priority.

Some variable annuities also offer enhanced death benefits, such as one that automatically locks in a death benefit value equal to the highest account value upon any policy anniversary date. Another type offers a specified annual percentage increase in the death benefit value. Enhanced death benefit options always incur additional costs and should be carefully considered before electing this additional protection.

Things to consider before buying a variable annuity

Variable annuities can be effective, tax-efficient tools for investors seeking:

- Choice of investment funds, that come with market risk
- Flexibility to reallocate a portfolio within a tax-deferred structure
- Protection to preserve a guaranteed benefit for designated beneficiaries

There are also several important considerations, including:

- In order to provide flexibility and choice, most variable annuities offer additional features and options, which may add to the complexity and cost of the annuity.
- Variable annuities can be an expensive way to invest relative to other investment options. While low-cost variable annuities do exist, total costs—including charges, management fees, and/or optional benefits and features—can easily exceed 3% per year.
- For commission-based variable annuities, early withdrawals that exceed the free annual withdrawal amount during the surrender charge period may trigger surrender charges, fees, and/or tax penalties, which could be substantial. For this reason, an investor should be prepared and able to hold an annuity through the full length of the surrender charge period which is typically between five and seven years.
- Withdrawals and distributions of taxable amounts are subject to ordinary income tax and, if made prior to age 59½, may be subject to an additional 10% federal income tax penalty.
- All references to guarantees arising under the annuity contract, including optional benefits, are subject to the claims-paying ability of the carrier.

ENDNOTES

1. S&P 500 Index: Feb. 14, 2020: 3380.16; March 20, 2020: 2305.92.

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