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Variable Annuities: The Good, Bad, and Ugly

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Variable annuities (VAs) have the tax rules of an annuity, but the value of one's assets can go up or down, depending on the investments one chooses. VAs are sold only by those who hold a securities license. Part 1 of the annuity series (10/7/09) covered fixed annuities. A future article will cover index annuities.

The Good: VAs have the same tax rules as a fixed annuity. One's gains are not currently taxed, as long as one does not pull money out. If one pulls money out before age 59.5, there is a 10% penalty as well as taxable income on gains.

Another benefit is that some VAs offer guarantees in the form of a death benefit, where one's heirs (upon your death) will always be able to receive at least the amount invested or the maximum amount the cash ever grew to. This guarantee occurs, even if one's investment account inside the VA has dropped in half.

The Bad: VAs are often referred to as "mutual funds inside an insurance wrapper" because the earnings are tax-deferred, but the underlying assets are the same or similar to those associated with mutual funds (stocks, bonds, and other Wall Street securities). The first bad issue is one then loses the tax benefit of long-term capital gains (where the maximum federal tax rate is 15%). All distributions of gains are taxed at ordinary income tax rates.

Another negative that the media keeps pointing out are the fees. It's not unusual that total fees, depending on the various "riders" purchased, can be 3-5%/year. These fees, like mutual

fund fees, are charged each year, whether your assets have gone up or dropped drastically. If one believes Warren Buffet's forecast that future stock market returns will only average 6-7%/year for the long-term future, it's hard to make money if one loses 3-5%/year in VA fees.

The Ugly: One is taking the same investment risk as if one owned individual stocks, bonds, or mutual funds. During the recent Wall Street Crash of the last 2 years, many were shocked to lose 30-50% of their money. They had no idea that they were in VAs instead of fixed annuities (where there is no risk of loss of principal).

The Ugly (unexpected): Another "gotcha" affects those who have purchased VAs with a rider that guarantee the death benefit will be no less than the principal invested or the maximum value reached. E.g. One invested \$200,000 in a VA (with IRA funds) 6 years ago and the value increased to \$400,000 in 2007. The Wall Street collapse dropped one's value to \$200,000 today but the death benefit rider stays at \$400,000 (your maximum value reached by the cash in the VA).

You are 71 and after age 70.5 you have to start taking required minimum distributions (RMD). Let's suppose the IRS actuarial table says that your life expectancy is 26.5 years. You'd normally think your RMD would be $\$200,000/26.5 \text{ years} = \$7,547$. However, a little known IRS rule can force you to distribute more because the RMD is based on your death benefit (less the cost of the death benefit rider) instead of your cash value. The

calculation is based on the current valuation of the future contract value which will force a substantially higher RMD for this and future years. This will accelerate the pro-rate deflation of the death benefit and result in higher taxes each year.

You may want to consult an expert if you've either lost substantial assets inside your VA or you are caught in this accelerated RMD of your IRA, which owns a VA with a "death benefit" rider. There are some "variable annuity rescue" planning strategies to help alleviate these two concerns.

Winter 2009-2010 Education Campaign: Note: Dr. Wong thanks the AZ Republic readers who have contacted him to schedule a talk for their church, Kiwanis Club, RV/Mobile Home Park, or real estate company. Please contact me for a future talk to your group.

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