The Tax Advantages of Annuities

How Tax Deferral and Guaranteed Lifetime Income Strategies Can Benefit All Consumers

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Overview

It has been well established that there are three key attributes that contribute strongly to sales of retail annuities: retirement income, principal protection, and tax deferral of earnings. The tax deferral component, intrinsic to most insurance products, has often been the source of debate, mainly as it is misinterpreted as a tax incentive for the wealthy. As we will demonstrate in this report, the tax deferral of annuity earnings is of greater benefit to middle income Americans, who comprise the largest segment of annuity owners, and plays a large role in their retirement income planning. The Insured Retirement Institute (IRI) contends that in the absence of tax deferral, middle income Americans would be faced with potentially burdensome restrictions to access insured retirement solutions.

Key Findings and Analysis

- The deferral of taxes on the inside buildup of annuity contracts is a key selling point for advisors and investors, as noted by 37% of advisors and 56% of annuity owners.
- The present tax status of annuities encourages long-term savings in the products due to a longer horizon needed to counteract the ordinary income tax due on earnings when funds are withdrawn, and to account for the fact that earnings are deemed to be withdrawn before principal.
- There is a strong tie-in between tax deferral and retirement income, as the removal of tax deferral would require investors to tap other personal assets to pay taxes on the annual build-up within the annuity, resulting in a lower level of funds available for retirement.
- The additional funds needed to pay these taxes could amount to significant dollars over the years, potentially adding the equivalent of at least 40 basis points to the effective cost of a variable annuity with a guaranteed lifetime withdrawal benefit and 45 basis points to one with the guaranteed minimum income benefit, and diminishing the annuity's appeal.
- As two-thirds of annuity owners have annual household incomes under $75,000, and (per EBRI) approximately half of earners in the second-to-lowest income quartile will be unable to cover their basic expenditures and uninsured health costs in retirement, additional taxation of annuities would negatively impact the group that is in the greatest need of supplemental retirement income.

Background

In December 2010, the National Commission on Fiscal Responsibility and Reform (the Fiscal Commission) published a report detailing its proposals to the fiscal challenges facing the United States. The report, The Moment of Truth, cited several ideas to address tax reform, including the elimination of more than 150 “tax expenditures,” generally understood to include the protections afforded to insurance products. In Section 2.1.3, the Fiscal Commission wrote that “Congress and the President must decide which tax expenditures to include in the tax code in smaller and more targeted form than under current law, recognizing that any add-backs will raise rates.” Later in this section, however, it was recommended that there must be provisions for several programs, including retirement savings and pensions.
Although the President’s proposed budget, released February 14, 2011, did not address any changes to the current tax treatment of annuities, this is only the beginning of the tax reform debate. *The Moment of Truth* document brought the tax treatment of annuity products into the limelight. Several leading economists and tax attorneys have opined that a complete overhaul to the U.S. tax system would put the tax benefits of annuities—particularly the deferral of taxes on the investment earnings (often referred to as inside build-up)—in jeopardy. This is key, as numerous studies show that tax deferral plays an important role in the decision to invest in an annuity, and that middle class investors would face significant tax impacts should this come to fruition.

According to the Insured Retirement Institute’s (IRI) 2010 Annuity Fact Book, 80% of annuity buyers in 2009 had household incomes of less than $100,000, and 64% earned less than $75,000. In a statement released on January 25, IRI President and CEO Cathy Weatherford affirmed that “we must continue to identify ways to incentivize retirement savings for all Americans. Now is not the time to consider potentially burdensome restrictions on the ability of those lacking financial security to access insured retirement solutions.”

**The Power of Tax Deferral**

Before delving into the impact of potential changes to annuity contract holders, we should first examine the reasons tax deferral is a valued benefit. The Internal Revenue Code (IRC) provides numerous incentives for individuals to save for retirement using annuities. When an annuity is purchased by individuals using after-tax dollars (known as a non-qualified annuity), investment returns in the annuity accumulate on a tax-deferred basis until funds are withdrawn. Additionally, transfers between investment options within a variable annuity do not trigger taxation, nor do certain instances of replacing one annuity with another. The tax-deferred treatment of the inside build-up within an annuity can amount to a significant sum over a period of many years, often resulting in a higher level of savings available at retirement compared to a similar investment that incurs income taxation every year.

By way of example, albeit simplistic, we compared the hypothetical growth of an annuity with that of an investment that is subject to ordinary income taxation on its earnings. (The latter may be thought of as an annuity without the benefit of tax deferral, although it was designed to be product-agnostic and, therefore, does not impose surrender charges.) Using a single, after-tax deposit of $100,000, an annual net return of 3%, and an ordinary income tax rate of 20% (the net amount, per Internal Revenue Service tables, associated with the average household income of non-qualified annuity holders in 2009), we calculated three balances: accumulated value of the annuity, surrender value of the annuity (incorporating income taxation and surrender fees), and net value of the non-tax-deferred investment. While there is no withholding on the latter, the net value reflects the taxes that are paid from another source, reducing the overall savings of the investor. Early withdrawal, or surrender, charges on the annuity are assumed to be a 7-year declining scale (7%, 6%, 5%, 4%, 3%, 2%, 1%, 0%). We will return to these calculations throughout this report.
As seen above, the accumulated value of the annuity is consistently the largest, and the gap widens with each year. The accumulated value is of importance as this is often the minimum amount payable as a guaranteed death benefit from the annuity. The gap between the annuity and the non-tax-deferred vehicle ranges is 5.1% after ten years and 10.4% after twenty, representing a significant advantage. Note that this assumes a 3% annual rate of return—the difference is magnified at higher investment returns.

As annuity earnings are taxed upon withdrawal, we also examined the case in which the annuity contract was fully surrendered. In the first seven years of the contract, when early withdrawal charges are assessed, the surrender value of the annuity was, not surprisingly, less than that of the non-tax-deferred investment. Yet, once the surrender charge period on the annuity ends, the balances of the two are running fairly even, with the surrender value of the annuity overtaking that of the non-tax-deferred investment after 15 years. As with the above, the crossover point gets earlier as the underlying investment return rises, yet is realistically in the range of 8 to 15 years. This may have a considerable impact on the retirement dollars annuities provide.

**Annuities and Retirement Income**

The tax-deferred nature of annuities is of great significance to both investors and their advisors. More than half (56%) of annuity owners surveyed for The Allianz *Reclaiming the Future* Study cited “an effective way to get tax-deferred growth potential” among the reasons they are satisfied with the product. And, according to Cerulli Associates, 37% of all advisors consider tax deferral a key
criterion when recommending an annuity to their clients—and this is most prominent (43%) in the independent channels, where most annuity sales occur.

Nonetheless, the key purpose of an annuity is to provide guaranteed retirement income, a function that is held in very high regard by advisors. Among the advisors surveyed by Cerulli Associates, 67% cited retirement income as a very important criterion when recommending an annuity. Yet, these two factors are not independent. An IRI survey conducted by Cogent Research in late 2010 showed that 60% of advisors believed that the guaranteed lifetime income provided by annuities should be promoted and further incentivized. Whether this is accomplished through guaranteed lifetime withdrawal benefits or lifetime annuity income benefits, tax deferral plays a significant role in maximizing guaranteed income.

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Sources: Insured Retirement Institute, Allianz Life Insurance Company of North America, Cerulli Associates, Cogent Research

Although the removal of tax deferral would not necessarily result in a smaller accumulated value (unless withholding is implemented), the owner would need to tap other sources for the funds to pay the tax, reducing long-term savings in the process. Using the example at the beginning of this chapter, the taxes payable on the non-tax-deferred $100,000 investment would amount to nearly $7,000 in the first ten years combined assuming a 3% annual return and 20% income tax rate. This jumps to nearly $13,000 with a 5% annual return. Therefore, removing the tax deferral incentive from annuities would effectively raise the cost of the product, diminishing its appeal.

We examine this effect for two key retirement benefit riders offered through annuities—the guaranteed lifetime withdrawal benefit and the guaranteed minimum income benefit. In both examples, the additional tax was converted into basis points to illustrate how the required cash reserve effectively impacts the cost of the riders.

**Guaranteed Lifetime Withdrawal Benefits**

Guaranteed lifetime withdrawal benefits (GLWB) provide a specified percentage of a guaranteed benefit base that can be withdrawn each year for the life of the contract holder, regardless of market performance or the actual account balance. The percentage is typically related to the age of the contract holder (and is often in the range of 4%-5%). The benefit base is usually the level of
premiums, although many have provisions that step up the benefit base to the account balance, periodically, if higher. Therefore, the GLWB provides both lifetime income and principal protection, two features in strong demand by investors and advisors.

The GLWB is an optional rider on a variable annuity contract, and was elected by nearly two-thirds (64%) of contract holders in the fourth quarter of 2009. Its cost ranges from 0.25% to 1.70% of the benefit base annually, with a weighted average of 1.03% (103 basis points), per Morningstar, Inc. Yet, if tax deferral were removed, contract holders would be responsible for paying taxes every year on the contract’s earnings. This would require that contract holders create, and fund regularly, an account from which the taxes would be paid. Assuming an interest rate of 3%, and no withdrawals, this would equate to an increase in the effective cost of a VA with a GLWB by 40 basis points, to 1.43%. This figure increases further for higher rates of return.

| Effective Cost of Annuity Retirement Riders, No Tax Deferral |
|-----------------|-----------------|-----------------|
| Benefit type    | Current weighted average rider cost | Effective cost with no tax deferral, 3% base return | Effective cost with no tax deferral, 5% base return |
| Guaranteed lifetime withdrawal benefit | 1.03% | 1.43% | 1.83% |
| Guaranteed minimum income benefit | 0.74% | 1.19% | 1.59% |

Sources: Insured Retirement Institute, Morningstar, Inc.

Annuitization and Guaranteed Minimum Income Benefits

IRI defines annuitization as the conversion of the annuity accumulation value to a fixed or variable income stream for the life of the annuitant(s) or for a specific period. (The annuitant is the person, frequently the contract owner to whom an annuity is payable, and whose life expectancy is used to calculate the income payment.)

Traditional annuitization calls for the conversion of the accumulated value of the annuity contract, an amount that is not guaranteed for variable annuities. In other words, market declines just prior to annuitization. The guaranteed minimum income benefit (GMIB) is also a popular variable annuity rider, selected by 26% of contract holders in the fourth quarter of 2009. The GMIB is designed to provide a base amount of income at retirement regardless of how the underlying investments performed. It guarantees that if the owner decides to annuitize the contract, payments are based on the greater of the amount invested, credited with a pre-stated interest rate, or the accumulated value of the contract.

The cost of a GMIB rider ranges from 0.20% to 1.15% of the benefit base annually, with a weighted average of 0.74% (74 basis points). Without tax deferral, the amount of cash reserves the contract holder would need to maintain to pay taxes would equate to 45 basis points annually assuming a 3% annual return, bringing the effective cost to nearly 1.20%.
Traditional annuitization, which does not guarantee a minimum base amount, would be impacted as well, by the need for an additional account from which to pay taxes. While there is no separate charge for this benefit, as it is built into every annuity sold in the retail market, the basis point equivalent of the cost of the cash reserve would be 60 basis points assuming a 3% rate of return.

**Demographic Impact**

The additional reserves required to sustain an annuity in the absence of tax deferral would be a significant burden on the population who presently owns the product—middle income earners. First, households in the middle class are far more likely to need supplemental income in retirement than their affluent counterparts. Second, contrary to the widely held belief that annuities are products for the wealthy, data shows us that middle income earners comprise the majority of annuity owners.

Research from the Employment Benefit Research Institute (EBRI) shows an inverse relationship between pre-retirement income level and their ability to pay for “basic retirement expenditures and uninsured health care costs.” Since 2003, EBRI has calculated a proprietary Retirement Readiness Rating™ for various segments of the population, indicating the percentages of individuals “at risk” of not having sufficient funds for retirement. The results by pre-retirement income level, as reported in its 2010 report, are shown below. Just more than half of earners in the second-to-lowest income quartile are expected to be unable to cover 100% of their anticipated basic retirement expenses, and one-fifth will be unable to cover 80% of these expenses. This is in contrast to the highest income quartile, in which only one-fifth cannot fully cover these expenses, and less than 5% will experience a shortfall in covering 80% of their anticipated expenses.
Fortunately, middle income Americans comprise the majority of annuity owners, showing some personal responsibility to closing this shortfall. Data from the IRI Annuity Fact Book shows that the majority of owners of non-annuity contracts (57%) had household incomes between $20,000 and $74,999. Eight of 10 annuity owners have annual household incomes under $100,000, and two-thirds have incomes under $75,000. The underlying data tells us that the average annual household income is just over $75,000.
Finally, let’s revisit the mathematical impact of tax deferral discussed earlier in this report, focusing on three different income bands. From the calculations, it is clear that annuities, with current tax treatment, are advantageous over longer periods, higher interest rates, and for those in lower tax brackets. All calculations assume that the annuity is assessed surrender charges in the first seven years, and the effective tax rate applicable to the specified income levels.

The exhibits that follow examine the average annual internal rates of return realized on an annuity that is surrendered after a stated number of years, at varying base levels of return on the underlying product. For example, for an investor at the $50,000 income level, an annuity that accrues at an annual rate of 3% would have a post-surrender rate of return of 2.54% after ten years, compared to 3.41% for a product on which investment returns are taxed annually. Extend the holding period to 15 years, and the internal rate of returns are roughly equal. At a 5% interest rate, the annuity return is advantageous by 10 years.

Moving up the income ladder, we see that the cross-over point—that is, the time at which the post-surrender annuity with tax deferral overtakes the product that is not tax deferred, is lengthened. While differences at the $75,000 income level are minimal compared to the $50,000 earner, the cross-over point for a $200,000 earner is between 10 and 15 years. In theory, the cross-over point may be extended for the highest earners as they are more likely to invest in products that offer returns in the form of capital gains.

Therefore, while middle income earners must still hold an annuity for a long period to realize the benefits of tax deferral, the length of time may be more palatable than that required for higher income earners. As nearly 60% of annuity buyers are over age 50, according to the IRI Annuity Fact Book (based on research done by the Gallup Association and Mathew Greenwald Associates), a ten-year holding period is reasonable—and the presence of tax deferral increases encourages long-term savings strategies at this critical age.
Looking at this data in tandem enables us to draw several key conclusions about the importance of annuity tax deferral:

- Additional taxation on annuities would negatively impact the group that is in the greatest need of retirement income.
- The effective increase in costs of income and principal protection benefits is onerous and would likely drive middle income investors away from annuities.
- Tax deferral benefits become more pronounced at holding periods of ten or more years, encouraging long-term investing while not deterring buyers at the point of sale.

**Tax Deferred, Not Tax-Free**

It is imperative to note that “tax deferred” does not equate to “tax-free.” The taxation of annuity income is governed by Section 72 of the IRC and generally applies to contracts issued after August 1982. As shown in the earlier example, when a contract holder begins to receive money from an annuity, distributions taken in excess of the amount invested are subject to taxation at the owner's ordinary income tax rate.
The methods of taxation differ by the way money is withdrawn from the annuity. The most common scenarios are for contract holders to make withdrawals from the accumulated value while the contract is in force, or to surrender the entire contract altogether. For most annuity contracts, the tax rule on withdrawals is “interest and earnings first,” meaning that interest and earnings are considered withdrawn first for federal income tax purposes. For example, if someone invested $25,000 in a fixed or variable annuity and the contract is now worth $45,000, the first $20,000 withdrawn is taxable. The remaining $25,000 is not taxed as it is considered a return of principal. Withdrawals are taxed until all interest and earnings are withdrawn; the principal then can be withdrawn without tax.

The “interest and earnings first” rule is intended to encourage the use of annuities for long-term savings and retirement planning. Congress decided that the advantage of tax deferral should not be accompanied by the ability to withdraw principal first, with no tax payable until all principal is withdrawn.

![Tax Treatment of Annuity Withdrawals and Full Surrenders](image)

**Note:** For illustrative purposes only. Above excludes the impact of any early withdrawal charges imposed on the value of the annuity by the terms of the contract.

**Source:** IRI 2010 Annuity Fact Book
Less common is for contract holders to annuitize—meaning that the accumulated value of the annuity is converted to an income stream for the life of the payee or for a specified period. (Note that this differs from withdrawals made via living benefit guarantees—these are considered withdrawals, not annuity payouts, as the contract is not converted under this circumstance.) The rules for the taxation of annuity payouts are complex, and are outlined in detail in Section 72 of the IRC. We present them in this report for completeness, as well as to illustrate the role of the accumulated value that has been building on a tax deferred basis.

The basic rule for annuity payouts (as distinguished from withdrawals or other non-periodic payments) is that the money a contract owner invests in the contract is returned in equal nontaxable installments over the payment period. This quantity, called the exclusion amount, is determined by using actuarial factors including life expectancies and total expected payouts from the annuity. The remainder of the amount received each year is treated as the earnings on the owner’s premiums and is included in income. The total amount that is received without taxes can never exceed the premiums the owner paid for the contract.

Therefore, owners of annuitized contracts realize two tax benefits—tax deferral of gains during the accumulation period, and exclusion of tax on a portion of payments during the payout period.
Conclusion

It is clear that tax deferral of annuity earnings is critical to the retirement income ultimately realized by the contract owner. Although the removal of tax deferral would not necessarily result in a smaller accumulated value, the owner would need to tap other sources for the funds to pay the tax, reducing long-term savings in the process. This would be cumbersome for the majority of annuity contract holders, who are primarily middle class.

*The Moment of Truth* document was not the first time the topic of annuity tax deferral was presented for debate. In 1992, for example, the President’s budget proposal included a narrowing of
the definition of annuities for which tax deferral would be permitted. While the 1992 proposal did not pass—and the current budget will likely leave the annuity rules unchanged, as well—the insurance industry must still remain prepared to demonstrate the impact that such a change would have on retirement savings in the U.S.

Tax deferral is a powerful motivator to save, particularly among the middle class. It prevents the need for the creation of a distinct account for the sole purpose of paying taxes on the annuity—which can amount to tens of thousands of dollars over a lifetime, an amount that is out of reach for most middle income earners. Additionally, the cost of the key annuity benefits of guaranteed lifetime withdrawals, guaranteed income, and guaranteed annuity payout levels, would add to this tax burden, further driving middle income investors—the ones who need supplemental retirement income guarantees the most—away from annuities.

Further, it must be emphasized that annuities are presently tax-deferred—not tax-free. Taxes on annuity income are generated at the time that funds are withdrawn, and are assessed at income tax rates, not capital gains rates. Therefore, the removal of the tax deferred status of annuities would not necessarily increase the tax revenue generated by the products, especially among middle income investors. Yet, it might very well result in reduced use of annuities, and most likely among the population that has come to rely on them the most.