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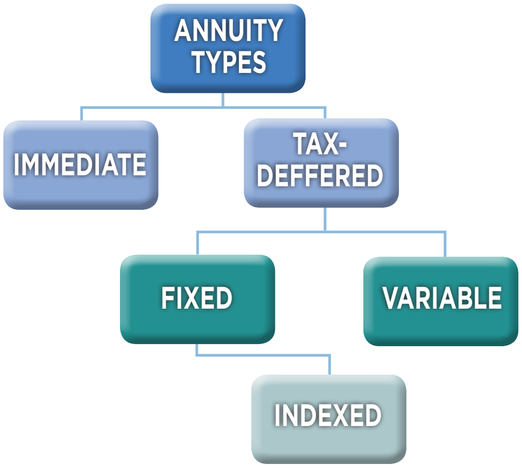
Financial Perspective

Tax-Deferred Annuities – The Good, The Bad, The Complex

Annuities have certainly received their fair share of bad publicity in recent years, some of it well deserved. They have been heavily promoted by financial service representatives in banks, insurance agents, and brokerage firms for a variety of reasons, including commissions, guarantees, and tax benefits. But like any good idea, those that manufacture, sell, or buy them can get carried away. We thought we would examine them in more detail in this issue.

Annuities are not outright investments, but rather contracts with an insurance company subject to contract law, the Federal tax code, state law, and the securities regulatory bodies. This creates complexity, as well as advantages and disadvantages.

There are two kinds of annuities: immediate and tax-deferred. Immediate annuities are a series of regular payments starting right now, for various lengths of time, perhaps for as long as you live. We'll discuss them in more detail in our next newsletter and in this newsletter's digital version under the news tab at **www.TheHGroup-Salem.com.**



A tax-deferred annuity (TDA) is an account in which the growth of a lump sum or regular payments into it are tax deferred until withdrawn or converted into an immediate annuity. The reason the growth is tax deferred is because there is a small element of life insurance; thus, it enjoys the same tax-free build up as a life insurance policy. This makes them similar to non-deductible IRAs. The gain over contributions is taxed at ordinary income rates. ***Since it is already tax-deferred, it rarely makes sense to own one inside an already tax-deferred IRA or similar retirement plan.***

Annuity contracts have four parties to them, and the same person can hold multiple titles, except that of the insurance company.

1) The **owner** has control over the other three parties, and special tax considerations come into play upon the death of the owner.
2) The **annuitant** is the person the company uses to determine a future lifetime income payment based on the life expectancy of that person. The death of an annuitant could also trigger death benefits in an annuitant-driven contract.
3) The **beneficiary** is the party that receives the value of the tax-deferred annuity if the owner (and in some cases the annuitant) dies.
4) The **insurance company** is the issuer of the contract and the party responsible for income and death benefit payments

Three Ways of Getting Your Money Back

1. Annuitize. Converting a contract to a series of payments (annuitization) is not very common, as we discuss in our digital edition.

2. Die with the contract in force and have the account transfer to the designated beneficiary, probate free and regardless of what your will or trust say. Your basis in the contract would be tax-free, but the gain in the contract is fully taxable to the beneficiary. Your beneficiary could take it all as a lump sum, annuitize it, or stretch it

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Special Issue
Tax-Deferred Annuities

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Understanding the Three Types of Tax-Deferred Annuities

Our lead article describes tax-deferred annuities in general. In this section, we examine the three main ways of investing within an annuity during the deferral phase.

1. Tax-Deferred Fixed Annuities

In a fixed annuity, the account is part of the general assets of the insurance company. With the annuity as part of the insurance company's assets, the guarantee is only good if the company remains solvent.

The company guarantees the principal and pays an interest rate based on its overall investment portfolio. Insurance companies are regulated by the states and are required to set aside reserves and invest a substantial majority of their assets into bonds and mortgages. Therefore, as a broad generalization, the interest rates on annuity contracts generally resemble yields of comparable maturities of treasury notes, corporate bonds, or mortgages. In May 2014, a five-year guarantee with a top-rated company might yield about 2% on a $100,000 premium.

2. Tax-Deferred Variable Annuities

In a variable annuity, your account is not co-mingled with the assets of the insurance company. You have a variety of portfolios—called sub-accounts—in which to invest. Some companies offer more than 30 sub-account choices, with a variety of management firms. ***Regardless of what happens to the insurance company, your return is based on the performance of the sub-accounts you have selected, minus fees.***

These sub-accounts have professional management, diversification, and built-in portfolio management fees, similar to mutual funds. Unlike mutual funds, everything that happens within them is a non-taxable event, including dividends, capital gains, portfolio changes, and rebalancing. This features make variable annuities appropriate for net income charitable remainder trusts with make-up provisions.

Variable annuities have a variety of enhanced death benefits. The most common is a guarantee that upon your death, your designated beneficiary will receive the greater of your account value or the amount you invested. Others guarantee that the beneficiary will receive the greater of your account value or the amount you invested, plus 5% per year.

In recent years, insurance companies have been very creative in adding so-called "living benefits" and more generous benefits to their contracts. The Guaranteed Income Minimum Benefit (GIMB) is popular one. A typical GIMB guarantees that no matter what happens to the stock market, your annuity value,[1] not your cash liquidation value, will always be the greater of the market value or your investment. Many offer a guaranteed annuity value of your investment plus a guaranteed return, such as 5%. However, you often don't get those guarantees until you have had the contract for 10 years.

There is no free lunch. Variable annuities are criticized for their high fees, ranging from 0.4% to 2.25% higher than for comparable mutual funds. This is a huge drag on performance, regardless of the tax benefits. The extra fees help pay for the extra benefits mentioned above. In the case of the GIMB rider you may get a lower rate when you annuitize than if you had purchased an immediate annuity with outside funds.

Tax-Deferred Index Annuities

Index annuities are fixed annuities that are heavily-promoted, greatly misunderstood, and subject to heavy regulatory scrutiny. They are touted to have the safety of a fixed annuity with the upside potential of a variable annuity. The company guarantees a base return and promises to pay you a certain percentage (the participation rate) of what a major stock index returns such as the S&P 500 (minus dividends) over a period of several years. It sounds too good to be true, and it is. Twenty years ago, when they actually did that, index annuities used to be a pretty good deal.

Now with lower interest rates, smaller participation rates, tighter state regulations, a mature bull market, and much more in fees and market adjustments, index annuities aren't such a good deal. ***In fact, in spite of the guarantees and slick brochures, you could actually lose money in an index annuity.*** If you don't believe us, check out the investor alerts from two major investment regulatory bodies. Simply Google "SEC + index annuities" or "FINRA + index annuities." They actually explain these complex instruments far better than we can.

[1] The annuity value is the amount upon which a lifetime income stream is calculated. (More about that in our next issue.)

Sell in May?

Rain showers bring May flowers and the perennial question about selling stocks in May then buying them back in November. Here's an update of monthly returns through 2013. We believe that fundamentals drive whether or not stocks should be bought or sold, not the page on the calendar turning. Last May's record close for the stock market certainly punctuated that point.

Average Annual Percentage S&P 500 Total Return by Month 1926-2013

Jan	Feb	March	April	May	June	July	Aug	Sept	Oct	Nov	Dec
1.26	0.28	0.58	1.33	0.35	0.84	1.61	1.11	-0.92	0.31	1.27	1.65

Percentage of Months of Positive Total Returns of the S&P 500 1926-2013

64	58	64	63	63	58	59	64	51	60	65	80

(Source: Ibbotson Associates/Morningstar, FPS calculations)

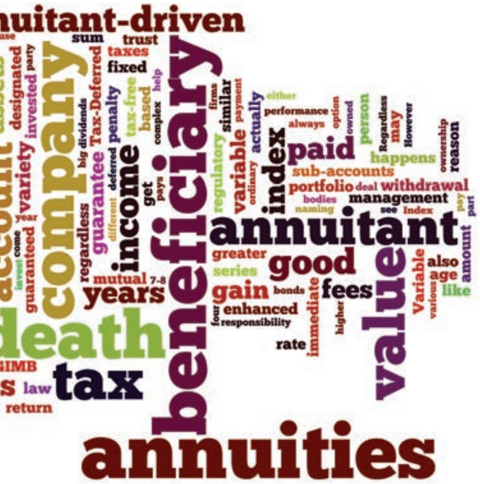
Are Your Annuities Structured Properly

As you can see by the other articles, annuities really are complex. "But wait—there's more," as the Sunday morning infomercial would say. We tried to keep it simple, but here are some other things you need to know.

As we said on page one, annuities operate under contract law with four separate parties to them. Pay attention to the actual contract wording, and the prospectus because annuity structure makes a big difference on when death benefits are paid, to whom they are paid, and who pays the taxes and potential 10% early withdrawal penalty.

Taxes

While the owner is alive, the tax liability for payments (either as a lump sum or as a series of annuity payments) is the responsibility of the owner. In a death situation, taxes are the responsibility of the beneficiary—but not always. The value of an annuity contract is included in the owner's estate.



Owner-Driven vs. Annuitant-Driven[1]

In owner-driven contracts, the cash value plus the enhanced death benefits (see the discussion under variable annuities) are paid on the death of the owner. This keeps things relatively simple. The beneficiary could stretch out the payments like a "stretch IRA." If the beneficiary were your spouse, he or she also has the option of assuming the contract as his or her own, changing beneficiaries, and continuing the tax deferral.

However, if you owned an annuitant-driven contract and died, only the cash value of the contract would be paid to your designated beneficiary, which could be considerably less than the guaranteed benefits. The enhanced death benefits in an annuitant-driven contract are paid on the death of the annuitant. In an annuitant-driven contract, all benefits are paid upon the annuitant's death, regardless of whether or not the owner dies. This can cause big tax problems and lost opportunities if the owner and annuitant are two different people.

For example, if you owned an annuitant-driven contract and the annuitant died, you—as the owner—would be responsible for the income taxes. If the beneficiary were under age 59½, you would also be responsible for a 10% early withdrawal tax penalty on the gain. Not a pretty situation!

Trusts

We generally recommend avoiding naming a trust as an owner or beneficiary of an annuity unless there is a very good reason for doing so. Depending upon the type of trust, the tax-deferral may not be possible. Also, the stretch-out opportunity may not be available.

If we could leave you any pointers they would be:

- Avoid naming different individuals as owner and annuitant, especially in an annuitant-driven contract. It's best to have the annuitant and owner the same in most cases.
- It's generally better to have the spouse as a beneficiary for the continuation option.
- For a husband and wife's Net Income Charitable Remainder Unit Trusts with deferred annuities, it's best to have two or more contracts with different annuitants to avoid flushing out all the accrued income on the first death. Alternatively, select from a handful of contracts that only pay death proceeds on the death of the contingent annuitant.
- Above all, check your contract. Know who you have listed as annuitant, owner, and beneficiary, and whether your contract is owner or annuitant-driven.
- **Given their cost and complexity, have a very good reason for using a tax-deferred annuity in the first place!**

[1] You can tell if your contract is owner-driven or annuitant driven by looking at either the prospectus or the actual contract under the heading of "Death Benefits."

The Team Advantage™

Ron Kelemen, Mary Way, and Larry Hanslits are independent CERTIFIED FINANCIAL PLANNER™ certificants. Together with Investment Advisory Associate Brenna Baucum, they jointly serve their clients as a team with over 80 years of combined experience. They work on a fee-only basis and do not accept any third party compensation or finder's fees. Their practice focuses on wealth planning and investment management for professionals, business owners, and retirees. They are advisory associates of The H Group, Inc., one of the largest independent fee-only registered investment advisory firms in the Northwest with 14 professionals in seven offices with over $550 million under active management.

About Ron Kelemen, CFP®

In practice since 1981, Ron is the author of *The Confident Retirement Journey,* a financial columnist for local medical and dental societies, and a contributing author of three financial planning reference books. He is frequently quoted in the national press and professional journals. He is active in Rotary and several non-profit organizations.

About Mary Way, CPA, CFP®

Mary joined the practice in 1995. She is also a non-practicing CPA with 16 years' experience in banking, business, and finance. She is a board member of the Salem Rotary Foundation, and like Ron, a past president of the Willamette Valley Estate Planning Council.

About Larry Hanslits, CFP®

In practice since 1985, Larry merged his practice with Ron's and Mary's in 2011. He sits on the investment policy committee of The H Group, Inc., provides advanced estate planning case writing services to attorneys nationwide, and is a teacher and a judge for the financial planning scholarship competition at Oregon State University.

About Brenna Baucum

Brenna joined the practice in 2013. She is a licensed investment advisory associate and is working toward her CFP® certificate. She is a member of the Rotary Club of Salem and an active volunteer for other organizations.

The opinions expressed in this newsletter are those of Ron Kelemen, CFP®, Mary Way, CPA, CFP®, Larry Hanslits, CFP®, and Brenna Baucum. They do not necessarily reflect those of The H Group, Inc. They are general comments that may not be appropriate for every individual. They should not be construed as legal or tax advice. All information is believed to be from reliable sources; however, we make no representation as to its completeness or accuracy. All economic information is historical and not indicative of future results.

Page 1 photo coutesy of Caren Ann Jackson

Team Update

At our day-long retreat in early January we set some ambitious goals in several areas. We've had a good time over the past three months looking at them weekly and checking them off. Never underestimate the power goal setting! We're conducting interviews for Lani's replacement and learning all the gee-wiz features of our new copier/printer/scanner.

Lani took two trips to Utah to visit family, take care of her mother, and attend a BYU Women's conference with her sisters. She's busy updating our "cookbook" for her successor.

Debbie was busier than usual this tax season processing requests for cash to cover income taxes, following last year's very strong investment results. She said that the advantage of having a 30-year old independent daughter is that she doesn't need to do much planning for her daughter's September wedding.

Brenna is spending most of this spring with her nose in the CFP study materials. She passed her first module with flying colors and is just about to sit for her second exam. She's been focused on a number of planning cases – more than we've ever had at any one time! June 3rd will be her one year anniversary with us. Time flies when you're having fun!

Larry and Laurie are completely moved into their new home in Salem. They are about to experience an increase in personal cash flow because daughter Jenna is graduating from OSU with a double major in finance and accounting—and a job! She starts work with Georgia Pacific in Atlanta right after graduation.

Mary, like Brenna, has been preparing a number of new financial plans and updates to old ones. She is busy getting ready to hit the ground running as the incoming President-Elect of the large Rotary Club of Salem. She and husband Steve enjoyed planting some very unique rhododendrons and helping celebrate their granddaughter's first birthday in Bend.

Ron and Kathy chipped away at their bucket list by taking a three-week trip to Peru and Ecuador, including the Galapagos Islands. A week after their return, Ron had elbow surgery to repair an old torn tendon injury. He's looking forward to physical therapy and being able to exercise his upper body. You can read about all of these adventures and see his photos of their trip at their blog entitled *Ron & Kathy's Midlife Adventures* at www.rwk777.blogspot.com. Ron's book is tentatively scheduled to be featured in the June *Encore* supplement to the *Wall Street Journal* around June 2.

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Good Bye, Lani!

Photo courtesy of Caren Ann Jackson

Lani Moore, who started with us in early 2003, announced her plans to retire near the end of June. She is the first cheerful face and voice a person encounters when walking into our office or becoming a new client. She was largely responsible for the scheduling and the high-touch and comfortable feel of our practice. Husband Jim will continue his job with the City of Salem for another couple of years, but Lani says she just has a lot of catching up to do with her gardening, grandchildren, and church activities. We will miss her and she says that she will miss us and our clients as her extended family away from home. Please stop by in the next four weeks to wish her well, or drop her a line at LaniM@theHGroup.com.

Want to read the weekly economic and market updates from our portfolio team?

They are available at our new landing page for The H Group, Inc. at **www.TheHGroup.com**, where you will also find quick links to our blog.

Tax-Deferred Annuities – The Good, The Bad, The Complex . . .

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out over various time periods, depending upon the terms of the contract. We'll discuss proper structuring and unintended consequences in a future article.

3. Withdrawals. The gain must come out first and be taxed as ordinary income, before you can have tax-free access to the amount invested. If you take money out before age 59½, a 10% income tax penalty is applied to the gain. Regardless of your age, most contracts—except for a handful of no-load annuities—have a declining early surrender charge to cover the agent's commission costs. On average, they start at 7-8% and decline each year for about 7-8 years. Most companies will permit a 10% free withdrawal of either your purchase payment or the account value.

Read more about annuities in our digital version under the news tab at **www.TheHGroup-Salem.com**