The Case for Using Advisory Variable Annuities with High-Earning and High-Net-Worth Clients

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The past few years have been some of the most interesting, chaotic, and enlightening of my career. A global pandemic, manufacturing and supply-chain shortages, a war overseas, and a worldwide re-imagining of what a “normal” workday looks like are just a few of the headlines that come to mind.

However, as a financial professional with an advanced planning and tax background, I would be remiss not to mention that one of the bigger hurdles now is soaring inflation—the highest in about 40 years.1 We were seeing a record expansion of the high-net-worth (HNW) and ultra-high-net-worth (UHNW) investor base prior to 2022.2 That investor base is increasingly more cognizant of the impact taxes will have on their financial futures, particularly in light of this record inflation and the bear market of 2022.

For the fiduciary financial professionals (“fiduciaries”) of high-earning clients who’ve maxed out their investments in qualified accounts, maintaining and growing their wealth will require finding tax-efficient strategies for their assets that also can mitigate the impact of inflation.

Fiduciaries must ask themselves if it is in their high-earning clients’ best interest to voluntarily pay taxes annually by remaining in tax-inefficient solutions or to defer and control when they pay taxes at a point later in their lives. Advisory investment-only variable annuities (IOVAs) may offer an answer. As such, it’s a good time for fiduciaries in the registered investment advisor, family office, and trust spaces to take a deeper look at these strategies.

Although paying taxes is inevitable and the amount owed may fluctuate, taxes also can cause a drag on earnings. In this article, we discuss how modern advisory IOVAs may fit into an asset-location plan to reduce or eliminate tax drag, where they may fit into ordinary income versus capital-gains tax planning, and how they can assist in combating the effects of inflation.

Making My Case Using ‘Just the Facts’

While researching and preparing for this article, I was reminded of a classic TV show. The show centered around a no-nonsense detective who delivered the oft-quoted line, “Just the facts, ma’am.” I think that kind of fact-based approach is the best way for me to demonstrate that it’s time for fiduciaries to take a fresh look at advisory IOVAs and their ability to mitigate the risks that taxes and rising inflation pose to long-term investors who are high earners in their working years.

We can’t say it’s time for a change without first acknowledging how our industry arrived in its current position. In other words, why have some fiduciaries been reluctant to consider variable annuities as a part of clients’ retirement strategies even if they make the most sense for helping them reach their financial goals?

To start, for years, annuity innovation was nonexistent. During a time when hedge funds, index funds, exchange-traded funds, structured investments, and other financial strategies all were evolving, most annuity products on the

KEY TAKEAWAYS

• Variable annuities weren’t always seen in a positive light, but innovation in the industry has created strategies that help meet the needs of modern HNW/UHNW investors. Advisory investment-only variable annuities (IOVAs) have no surrender charges, have institutionally priced investment options, and can be integrated into many financial planning platforms.

• Reallocating some tax-inefficient investments to a variable annuity can be an effective strategy to combat inflation.

• Modern advisory variable annuities offer clients opportunities to benefit from compounding growth through tax deferral and legacy planning while also putting the client in control of when taxes are paid through the timing of withdrawals.
market were stagnant. Variable annuities often have been seen as being a conflict of interest, expensive, and complicated. But here is the good news: These generalizations are no longer true due to a renaissance in the annuity world. So, allow me to present some information that will help put those old perceptions to rest.

FACT: ANNUITY INNOVATION IS HERE—IT’S BEEN HERE
Thankfully, for fans of no-nonsense approaches, modern advisory annuities are designed for the way fiduciaries do business. It took some time, but when innovation finally filtered into the world of annuities, it led to a wave of changes for the products, which now address the numerous market demands of fiduciaries and their clients.

Some annuity carriers now offer advisory variable annuities that have institutional priced investment options, and allow fiduciaries to bill their advisory fees directly on the annuity without creating taxable events or reducing the clients’ benefits, and they do not pay commissions. Admittedly, the many optional riders available for an additional cost with some annuities can be complex, but it may be worth the time it takes to learn about them. In this article, however, we are focusing only on advisory IOVAs.

FACT: ASSET LOCATION CAN BE AS IMPORTANT AS ASSET ALLOCATION
Most fiduciaries know the importance of asset allocation—the strategy of balancing risk with returns for clients based on their goals, risk tolerances, and time horizons. Yet, asset location is an often-overlooked planning strategy that is turning out to be just as important.

Thoughtfully locating an asset means considering placing a client’s tax-inefficient investments—such as taxable bond funds, real estate investment trusts (REITs), alternative strategies, international funds, and actively managed funds—into a tax-deferred account.

A 2021 study conducted by financial tech giant, Orion, showed the vast majority of investors (90 percent) agree taxes can eat into their portfolios the same way volatility can. The same study also showed that most investors (79 percent) think their advisors should focus on minimizing tax obligations. And why wouldn’t investors want this? The cost of taxes from your average large-cap fund can exceed 200 percent of the expense ratio.

The Penn Wharton Budget Model showed that household equity wealth increased 40 percent in 2021, which was twice as fast as in any year since 1990. HNW clients control more than 45 percent of total investable assets held by all households in the United States. In my experience, these investors generally already have reached their contribution limits in qualified accounts and are accumulating substantial assets in nonqualified taxable investment accounts. Of course, nonqualified taxable accounts are subject to annual tax reporting.

In addition, some financial professionals are unaware that certain asset classes and strategies within nonqualified accounts already are taxed at ordinary income-tax rates, not capital-gains tax rates. I discuss the importance of this point below.

FACT: ACTIVITY CREATES TAX INEFFICIENCY
In 2021, 81 percent of U.S. equity funds made capital-gains distributions on an average of 12 percent of net asset value (NAV), and The Penn Wharton Budget Model surmises that this factored into an estimated $200–billion increase in tax liability for U.S. households. In an actively managed fund, virtually any activity in the fund creates a taxable event for clients (even though the client may not have actually sold a position). Clients have no control over when these events happen or how often. This level of tax-inefficiency in actively managed funds also creates a circular problem where volatility drives fund outflows, forcing fund managers to sell appreciated securities to meet redemptions, which in turn drives greater tax inefficiency. Those necessary sales to meet redemptions have even resulted in litigation when high-earning clients receive surprisingly large tax bills. Many funds have been struggling because of market ups and downs, and if outflows continue, clients could face the double whammy of fund losses plus a big capital-gains distribution as more fundholders jump ship. This is something to keep an eye on.

In the case of advisory IOVAs, however, the same sort of activities conducted by subaccount managers would have sheltered clients from active management taxation, which would have left more of their money invested. Variable annuity clients typically do not pay current income tax for transfers among investment options and any earnings are generally tax deferred. Taxes are incurred when the client makes a withdrawal or surrenders the contract, receives an income payment from the contract, or upon payment of a death benefit.

In this hypothetical example, we compare two separate $100,000 investments made in 2012 in a large-cap blend fund portfolio:

- One investment is in a taxable account; the other is in a tax-deferred nonqualified account.
- After 10 years, the taxable account is worth $270,000 and the tax-deferred account is worth $329,000.
- That’s a net difference of 18 percent. In fact, the benefits of deferring tax payments really start to accelerate after the 10-year mark, which is why variable annuities can be a viable option for investors who won’t necessarily need the money for 10 to 20 years or more.

TAXES AREN’T THE ONLY DRAG ON INVESTMENT GROWTH
Fees also take a bite out of any earnings. Historically, the fees associated with
variable annuities made them undesirable to many fiduciaries working in the registered investment advisor, family office, and trust channels, and for good reason. For some, the cost of managing a variable annuity might not have been worth the headache they may have experienced. Seeing an opportunity, annuity providers developed modern advisory IOVAs designed to be cost-conscious. The sheer size and scale of many providers today allow them to provide competitive pricing. Clients can choose from a variety of institutionally priced investment options managed by the same fund managers of investments they previously held, but they keep more of their money working for them by growing it tax-deferred and compounding over time.

**BEWARE OLD BREAK-EVEN STUDIES**

Of course, I’m well aware there are older studies out there saying the cost of variable annuities makes it hard for clients to break even and get after-tax value from the tax deferral that comes with a variable annuity. However, I would caution you that those studies may not be applicable today. I often hear from fiduciaries who would not recommend variable annuities to their high-earning/HNW clients as a tax-management strategy. But this view fails to consider some of the nuances of our tax system. The appreciation above cost basis, upon distribution, is taxed at ordinary income rates on nonqualified variable annuities. However, as mentioned above, assets and strategies held in taxable accounts can be a mixed bag of preferential long-term tax rates and ordinary income–tax rates on an annual basis separately from when the owner of the assets decides to sell them. Fiduciaries must be able to navigate both our progressive marginal federal income–tax system and the flatter tax system for long-term capital assets at the same time.

For instance, in 2023, a married couple filing jointly that makes more than $693,750 would be in the nation's highest tax bracket at 37 percent. But that doesn’t mean that this married couple is paying 37 percent of everything they
make to Uncle Sam. On the contrary, the married couple would pay a rate of 37 percent on any income over $693,750. Because of the impacts of compound growth and deferring tax payments until a time when the client decides to take withdrawals, any potential savings an investor would receive from paying long-term capital-gains taxes (20 percent plus 3.8 percent net investment income tax) on a yearly basis or through tax harvesting could be eclipsed by the earnings realized in a nonqualified annuity. How? Let’s dig deeper for the facts.

Using the same married couple as a hypothetical example, their top capital-gains tax rate is 23.8 percent because we must remember that investors making more than $250,000 married filing jointly are subject to the 3.8 percent net investment income tax, which isn’t indexed for inflation. At certain levels of income, the couple’s effective ordinary income-tax rate will be less than the capital-gains rate (or combination of capital-gains rate and net investment income tax). At other levels, the rates will be very close.

This brings me to another point: Taxable income levels don’t stay the same over the course of a person’s lifetime in most cases. Generally, we start our careers in lower tax brackets, work into higher brackets, and may go into lower brackets later in retirement. Timing and control of the recognition of income can help retain more of the value of assets. If we combine tax deferral and asset location, we create the opportunity to defer the recognition of ordinary income to a future, lower tax bracket.

CAPITAL GAINS VS. ORDINARY INCOME—THE BIG SURPRISE
As I write this paragraph, I can hear some readers saying, “Rule of thumb says long-term capital-gains taxes are always better than ordinary income-tax rates.” And before 2018, those folks likely would have been correct. But the Tax Cuts and Jobs Act rendered that argument moot in some circumstances. There are intervals or “windows” when the effective ordinary income-tax rates may be lower than long-term capital-gains rates.

Let’s revisit my earlier comments regarding asset location, and that certain asset classes and strategies within nonqualified accounts already are taxed at ordinary income-tax rates, not capital-gains tax rates. This increases clients’ taxable income, often in their high-earning years. Clients could take advantage of strategies that do two things—lower their unexpected taxable income and reduce the tax drag that tax-inefficient investments can cause during their working years.

THE BIGGER SURPRISE—ADVISORY IOVAs CAN DO BOTH
In addition to earnings compounding tax-deferred over time, clients who locate tax-inefficient assets and strategies in an advisory IOVA also have the power to control when they pay taxes by choosing when they take withdrawals. For many HNW and UHNW clients and dual-income couples, peak saving years are also peak earning years and peak taxable-income years. These clients likely will target to be in a lower tax bracket once they retire and no longer are earning the money they were before. So, their withdrawals won’t be taxed as much as they would have been in their working years.

CONTROLLING INCOME TO AVOID OR REDUCE IRMAA
Medicare Part B and Part D premiums are based on modified adjusted gross income. The ability to hold down gross income may be beneficial for avoiding or reducing the income-related monthly adjusted amount (IRMAA) at higher income levels.

PHASE-OUTS OF DEDUCTIONS AND CREDITS ARE OFTEN OVERLOOKED
Many financial advisors tend to forget about the effect that phase-outs of deductions and credits and the phase- outs of others have on taxes. Phase-outs of deductions and credits are some of the most complicated and overlooked tax-planning concepts for clients and many financial professionals. Uncontrolled distributions from investments can push clients into higher marginal tax brackets. Phase-outs of deductions or credits can impact high-earning clients due to reduced benefits, increased effective tax rates, and decreased after-tax gains.

There are clients who are affected by multiple phase-outs, which compounds the negative effect on their earnings. Some high-earner phase-out pitfalls include Roth individual retirement account (IRA) contributions as well as the adoption credit. Phase-in tax provisions include the 3.8 percent net investment income tax and the 0.9 percent Medicare surtax on wages. Some phase-out provisions are indexed for inflation and some are not, which will affect more clients over time by putting them over phase-out cliffs as they receive nominal raises during their careers.

HOW STATE AND LOCAL TAXES (SALT) IMPACT GROWTH
The Tax Cuts and Jobs Act changed the SALT cap, impacting HNW and UHNW clients the most because deductions are worth more to HNW income-tax filers. Also, depending on where those clients live, the impacts of those changes also can be felt to varying degrees because different states will tax residents differently. Currently, 22 states have tax brackets, personal exemption thresholds, or standard-deduction thresholds that are not indexed for inflation. The fact I’m pointing out here is that there is a lot more to consider than just how an investment is taxed on the surface. Locating actively managed investments and strategies that generate annual income that the client doesn’t currently need or want into an advisory IOVA is a strategy that fiduciaries could consider to reduce or eliminate the possibility of clients triggering unforeseen taxes.
VARIABLE ANNUITIES FOR TAX-EFFICIENT WEALTH TRANSFER

Some annuity owners might not need the money themselves and instead are interested in legacy planning. Another common objection regarding using nonqualified variable annuities is that clients lose the step-up in cost basis at the death of the owner. What is the likelihood that beneficiaries will immediately liquidate investments that received a step-up in cost basis to avoid further compounding that will be subject to taxation? Beneficiaries will want to spend their inheritances at some point.

Nonqualified variable annuities don’t get a step-up in cost basis because taxes have been deferred and can be deferred for years. Nonqualified variable annuity owners are not required to take distributions until the annuity maturity date. The trade-off for not getting a step-up in cost basis is the tax deferral, bypassing the probate process, and allowing natural beneficiaries to control taxable distributions over their life expectancies through a nonqualified stretch provision. With the stretch provision, beneficiaries of nonqualified annuities outside of trusts have the flexible option of receiving an annual required minimum distribution of the contract value over their life expectancies. This option allows the money to be reallocated to fit beneficiaries’ investment/risk profiles and stay invested in the markets to continue the growth potential of the asset.

Finally, nonqualified annuities also may be used to achieve tax deferral within various trusts, and the growth within the annuity would not be counted as net distributable retained income subject to punitive trust tax rates; or they can be used to efficiently transfer wealth to charitable causes when the client passes away.

FACT: INFLATION ISN’T A TAX, BUT IT CAN ACT LIKE ONE

You don’t have to be a detective to see that rising inflation reduces consumer buying power. Just look at the Bureau of Labor Statistics’ CPI Inflation Calculator for a trip down price-comparison lane to see how far your client’s dollar isn’t stretching under the current 40-year-high inflation rate (see figure 1). Since 2010, we’ve seen a more than 50%-percent increase in the prices of things such as hospital services and beef, and even water and sewer services. Historically, the Federal Reserve Bank tries to hold inflation to a year-over-year average of 2 percent. The U.S. inflation rate peaked in June 2022 at 9.1 percent. To put that into hard figures, $1,000 in 1990 would buy only $425 in 2023 goods and services. Many retirees are now having to alter their lifestyles dramatically or even go back to work.

Inflation can have a dramatic impact on even HNW clients. Well-off retirees who had nice financial cushions are finding themselves cutting back on things they wanted such as travel, new cars, or eating at restaurants.

INFLATION SPIKES HIGHER

What are some impactful investment strategies that can help counter inflation? Some of the commonly used offensive assets for combating inflation. In fact, 94 percent of financial advisors working with HNW clients consider alternative investments to now be an important initiative. Defensively, fixed income funds are a strategy that may be used to minimize the effects of rising inflation on clients’ portfolios. However, these offensive and defensive strategies are also tax inefficient.

How do you help high-earning clients with tax-inefficient assets battle inflation? If you’re thinking you can reallocate some of them in an IOVA and manage tax drag, you’ve made a great observation. Many of these offensive and defensive strategies can be found in an advisory variable annuity’s underlying investment options managed by well-known fund managers.

WRAP-UP OF THE FACTS OF THIS INVESTIGATION

Variable annuities weren’t always seen in a positive light, but innovation in the industry has created strategies that help meet the needs of modern HNW/UHNW investors. Advisory IOVAs have no surrender charges, have institutionally priced investment options, and can be integrated into many financial-planning platforms.

**Average Consumer Price Index (CPI) by Decade**

As of May 2023

Consider ing annuities for HNW and UHNW clients presents an opportunity for fiduciaries to separate themselves from their peers and help their clients maintain and seek to grow their wealth for years to come.

Modern advisory variable annuities offer clients opportunities to benefit from compounding growth through tax deferral and legacy planning while also putting the client in control of when taxes are paid through the timing of withdrawals.

Compounding growth and tax deferral can lead to significant growth in assets and also allow time for the client to possibly move into a lower tax bracket before taxes are actually paid on those assets.

Reallocating some tax-efficient investments to a variable annuity can be an effective strategy to combat inflation.

CASE CLOSED—ANNUITIES DESERVE A SECOND LOOK
Now that you’ve seen the compelling evidence about how variable annuities can assist in decreasing the impact of inflation and lowering tax drag, I hope you’ll look at these products with a new perspective. Discussing the features offered by this strategy with clients may just provide the opportunities they’ve been looking for.

ENDNOTES
5. “Why Taxpayers Owed $500 Billion in Taxes When They Filed This Year,” Budget Model, Penn Wharton University of Pennsylvania (May 23, 2022).
7. See endnote 5.
10. See endnote 8.
15. See endnote 1.
17. See endnote 1.

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