The Case for Using IOVAs with High-Earning and High-Net-Worth Clients

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About This White Paper

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While advisory annuities have become increasingly popular with fiduciary financial professionals, there are still many who may not understand how these strategies have the potential to significantly improve outcomes for their high-net-worth (HNW) and ultra-high-net-worth (UHNW) clients. This paper addresses the many scenarios where an annuity can provide opportunities for wealthier clients, while helping them avoid paying unnecessary taxes. Mr. Williams presents compelling facts to make the case for considering annuities as part of a HNW/UHNW client's comprehensive financial plan.

About the Author

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The last few years have certainly 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 to not 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 that we saw in 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 can also 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.

While paying taxes is inevitable and the amount owed may fluctuate, taxes also can cause a drag on earnings. In this paper, 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 combatting the effects of inflation.

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Making My Case Using "Just the Facts"

While researching and preparing for this paper, I was reminded of a classic TV show. The show centered around a no-nonsense LAPD 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 taxes and rising inflation pose to long-term investors who are high earners in their working years.

We couldn't have said, "it's time for a change" without first acknowledging how our industry arrived in its current position; meaning, why were some fiduciaries reluctant to consider variable annuities as a part of clients' retirement strategies even if they made the most sense for helping them reach their financial goals?

[1] Vanova, Irina. "Inflation Hit 9.1% in June, Highest Rate in More Than 40 years." *Money Watch*. CBS News, July 13, 2022. Accessed May 16, 2023.
[2] "World Report Series Wealth Management 2022: Customer-First Strategy." Capgemini Research Institute, June 15, 2022.

To start, for years, annuity innovation was nonexistent. During a time when we saw the evolution of hedge funds, index funds, ETFs, structured investments, and other financial strategies, most annuity products on the market were stagnant. Variable annuities were often seen as being a conflict of interest, expensive, and complicated. 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 do not pay commissions, offer institutionally priced investment options, and allow fiduciaries to bill their advisory fees directly on the annuity without creating taxable events or reducing the clients' benefits. 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 paper, 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%) agree taxes can eat into their portfolios the same way volatility can. The same study also showed that most investors (79%) think their advisors should focus on minimizing tax obligations.[1] And why wouldn't investors want this? The cost of taxes from your average large-cap fund can be over 200% more than the expense ratio.[2]

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The Penn Wharton Budget Model showed that household equity wealth increased 40% in 2021, which was twice as fast than in any year since 1990.[3] HNW clients control more than 45% of total investable assets held by all households in the U.S.[4] In my experience, these investors generally have already 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.

[1]Rosenberg, Andy. "Wealthtech Insider: 3 Surprises from Orian's Tax Management Survey." *Digital Wealth News*, November 22, 2021.
[2]Anticipate Potential Tax Impacts, *BlackRock*, April, 2023.
[3]"Why Taxpayers Owed $500 Billion in Taxes When They Filed This Year." *Budget Model*. Penn Wharton University of Pennsylvania, May 23, 2022.
[4]"U.S. High-Net-Worth and Ultra-High-Net-Worth Markets 2021: Evolving Wealth Demographics, 2021," *The Cerulli Report*, 2021.

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

Fact: Activity Creates Tax Inefficiency

In 2021, 81% of U.S. equity funds made capital gains distributions on average of 12% 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![1] 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.[2] Those necessary sells to meet redemptions have even resulted in litigation when high-earning clients receive surprisingly large tax bills.[3] 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.[4]

In this hypothetical example, we compare two separate $100,000 investments made in 2012 in a large-cap blend fund portfolio[2]:

- 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, while the tax-deferred account is worth $329,000.
- That's a net difference of 18%! 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 RIA, 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.

[1] "Why Taxpayers Owed $500 Billion in Taxes When They Filed This Year." *Budget Model*. Penn Wharton University of Pennsylvania, May 23, 2022.

[2] Prince, Daniel and Arciaga, Kaitlin. "Keep More of What You Earn: How advisors can help clients build tax-efficient portfolios." iShares by BlackRock, 2020.

[3] Lacurci, Greg. "Vanguard Created Big Tax Bills for Target-Date Fund Investors, Lawsuit Claims." *CNBC.com*, March 15, 2022.

[4] 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.

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 no longer be relevant, because they assume higher costs that don't exist with today's modern, investment-only variable annuities and in a lower tax environment. IOVAs may make sense for certain investors with long investment horizons and an expectation of being in a lower tax bracket during retirement.[1]

Is the Tax Deferral You Get with a Variable Annuity Worth Paying For?

While the benefits of tax deferral are largely driven by harnessing the power of compounding returns, the amount of the potential benefit will be influenced by many factors.

Let's take a look at a more current, break-even analysis. The key factors considered for this illustrative example include the relative cost of a tax-deferred solution and the expected applicable tax rates. Additional factors to consider are a higher tax rate during accumulation when high-earning clients are employed and a potentially lower tax rate in retirement.

Nonqualified Assets	Annual Expenses/Fees	Income-Tax Rate		Capital Gains Tax Rate
		Pre-Retirement	Post-Retirement	
Taxable Account	0.68%	35%	24%	18.8%
Tax-Deferred Variable Annuity	0.70%	35%	24%	N/A

What's the Break-Even?

Gross Annualized Return	Tax Deferral Break-Even Year	
	0% of Total Return Subject to Income-Tax Rates Annually	25% of Total Return Subject to Income-Tax Rates Annually
4%	24	8
5%	18	7
6%	15	6
7%	13	5
8%	11	**5**

Source: Pacific Life Tax Deferral Calculator 2023. This example is hypothetical and does not represent any actual investment. It assumes that the reported Break-Even Year aligns with the "retirement year" in which the post-retirement tax rate assumptions become effective and there is a full liquidation of the tax-deferred assets. Lower tax rates on capital gains and dividends would make the investment return for the taxable investment more favorable, thereby reducing the difference in performance in the example shown. Actual tax rates and assets (e.g., capital gains and qualified dividend income) may vary for different taxpayers.

[1]Reichenstein, William. "Retirement Planning: Annuities and When They May Make Sense." *AAII Journal 2003*. American Association of Individual Investors, July 2003.

The level of tax efficiency of a portfolio is a key consideration for evaluating the potential benefits of tax deferral. A passive ETF focused on equities may be very tax efficient and stand to have little benefit from being included in a tax-deferral strategy. However, a well-diversified portfolio is likely to be composed of a mix of dividends, income from bonds, asset turnover from active management, alternative investments/strategies, and distributions of capital gains to name a few. With diversification, risk, and growth objectives prioritized over tax efficiency, the potential results of a tax-deferral strategy become more compelling. In the table above you can see that for moderate shifts across the tax-efficiency spectrum, the break-even year—the minimum holding period for the benefits of tax deferral to outweigh the costs of a variable annuity—reduces dramatically and may be a valuable tool for driving optimal financial outcomes. Here, we have assumed that 25% of a client's annual return is generating taxable income.

Fact: Ordinary Income Tax Isn't a Crime

The tax treatment of recognized gains from variable annuities is an objection 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-tax rates on nonqualified variable annuities. However, as we have mentioned previously, assets and strategies held in taxable accounts can be a mixed bag of preferential long-term tax rates and ordinary income-tax rates on the 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%. But that doesn't mean that married couple is paying 37% of everything they make to Uncle Sam. On the contrary, the married couple would pay a rate of 37% 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% plus 3.8% 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% because we must remember that investors making more than $250,000 married filing jointly are subject to the 3.8% 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.[1] 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.

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[1]Elkins, Kathleen, "Here's the Age at Which You'll Earn the Most in Your Career," *Money*, November 2, 2018.

Capital Gains versus Ordinary Income—the Big Surprise

As I write this paragraph, I can already 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 would likely be correct; but the Tax Cuts and Jobs Act rendered that argument moot in some circumstances.[1] 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 are already taxed at ordinary income-tax rates, not capital-gains tax rates. This increases clients' taxable income, often in their high-income-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.

Here's the big surprise—advisory IOVAs can do both!

In addition to any earnings compounding tax-deferred over time, by locating these tax-inefficient assets and strategies in an advisory IOVA, clients 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 taxable-income years. These clients will likely target to be in a lower tax bracket once they retire and are no longer 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 I talk to tend to forget about the effect that phase-outs of deductions and credits and the phase-ins 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 IRA contributions as well as the Adoption Credit. Phase-in tax provisions include the 3.8% Net Investment Income Tax and the 0.9% Medicare surtax on wages. There are phase-out provisions that are indexed for inflation and some that are not, which will affect more clients over time by putting them over phase-out cliffs as they receive nominal raises during their careers.

[1] "Tax Cuts and Jobs Act of 2017 (TCJA)." *Legal Information Institute*. Cornell Law School, May 2022.

How State and Local Taxes (SALT) Impact Growth

The Tax Cuts and Jobs Act changed the SALT cap, impacting HNW and UHWN clients the most since 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, there are 22 states that have tax brackets, personal exemption thresholds, or standard-deduction thresholds that are not indexed for inflation.[1] 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 fiduciaries could look at to reduce or eliminate the possibility of clients triggering unforeseen taxes.

Variable Annuities for Tax-Efficient Wealth Transfer

At this point, it's also important to point out that some annuity owners might not need the money themselves and instead are interested in legacy planning. Another common objection I get 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 of 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 in 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.

> *The trade-off in 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.*

[1]Walczak, Jared. "As Inflation Rises, So Will Tax Bills in Many States." Tax Foundation, October 19, 2021.

Fact: Inflation Isn't a Tax, but Can Act Like One

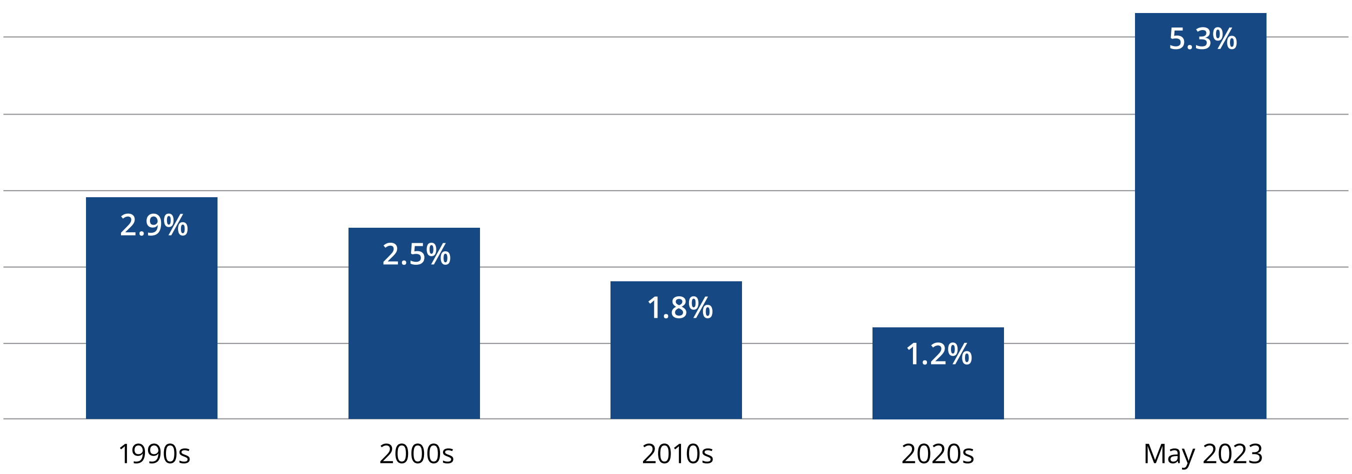
You don't have to be a detective to see that rising inflation reduces consumer buying power. Just look at the Bureau of Labor Statistics' CPI Inflation Calculator for a reality-inducing trip down price-comparison lane, and see how far your client's dollar isn't stretching under the current 40-year high inflation rate.[1]

Since 2010, we've seen more than a 50% increase in the prices of things such as hospital services and beef, and even water and sewer services.[2] (Know any clients who might need some of those goods and services?) Historically, the Federal Reserve bank tries to hold inflation to a year-over-year average of 2%. The U.S. inflation rate peaked in June 2022 at 9.1%![1] To put that into hard figures, $1,000 in 1990 would only buy $425 in 2023 goods and services.[3] Many retirees are now having to dramatically alter their lifestyles or even go back to work.

Inflation can even have a dramatic impact on HNW clients. Well-off retirees who had nice financial cushions are finding themselves cutting back on things they wanted to do such as travel, buy new cars, or eat at restaurants.[4]

Inflation Spikes Higher[2]

Average Consumer Price Index (CPI) by Decade 5/2023



What are some impactful investment strategies that can help counter inflation? Commodity strategies, natural resources (gold, energy), real assets (securities), and REITS are some of the commonly used offensive assets for combating inflation. In fact, 94% of financial advisors working with HNW clients consider alternative investments to now be an important initiative.[5] 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. But fear not, gumshoes, there is an answer.

[1] Vanova, Irina. "Inflation Hit 9.1% in June, Highest Rate in More Than 40 years." *Money Watch*. CBS News, July 13, 2022. Accessed May 16, 2023.

[2] BlackRock Investments, LLC. "Are the Prices Right? Understanding Inflation: A Student of the Market Special Edition." BlackRock Inc., June 30, 2021; Bureau of Labor Statistics. "News Release: Consumer Price Index--May 2023 (USDL-WE-1301)." Last accessed 6/27/2023.

[3] U.S. Bureau of Labor Statistics. "CPI Inflation Calculator." Last accessed 6/27/2023.

[4] Sahadi, Jeanne. "'This is Not the Retirement I Envisioned.' How Retirees Are Getting Hit by Inflation." *CNN Business*. CNN.com, May 27, 2022.

[5] Horton, Chayce. "High-Net-Worth Investors Embrace Alternative Investments." Cerulli Associates, January 17, 2023.

Inflation Offense and Defense in a Portfolio[1]

ASSET CLASS	OFFENSE	DEFENSE
	Commodity Strategies	Inflation-Protected Bond
	Natural Resources (Gold, Energy, Mining)	Global Inflation-Protected Bond
	Real Assets (Securities)	Unconstrained Fixed Income
	REITs	Floating-Rate Income

For that, let's now take the pin out of the asset location discussion. So, 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 created strategies that help meet the needs of modern HNW/UHNW investors. These advisory investment-only variable annuities have no surrender charges, have institutionally priced investment options, and can be integrated into many financial-planning platforms.
- Considering 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 while also allowing time for the client to potentially move into a lower tax bracket before taxes are actually paid on those assets.
- Reallocating some tax-inefficient 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.

[1]BlackRock Investments, LLC. "Are the Prices Right? Understanding Inflation: A Student of the Market Special Edition." BlackRock Inc., June 30, 2021.