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Whither the Variable Annuity?

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Public Law 108-27, “The Jobs and Growth Tax Relief Reconciliation Act of 2003,” was signed by President Bush on May 28, 2003. This law, by changing the relationship between tax rates on ordinary income and the tax rate on dividends and long-term capital gains, changes the playing field for variable annuities and possibly other insurance products.

Sales of variable annuities should fall relative to sales of fixed annuities. Insurance companies may require a new assessment of product development.

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Summary of key changes

The 2003 Tax Rate Schedules have been revised to reflect the following changes.

The tax rate brackets of 27 percent, 30 percent, 35 percent and 38.6 percent, have been reduced to 25 percent, 28 percent, 33 percent and 35 percent, respectively. Lower brackets of 10 percent and 15 percent probably do not contain many prospective purchasers of variable annuities.

Here are the new tax rates for married people filing jointly:

Annual Income	Tax Rate
$0 - $14,000	10%
$14,000 - $56,800	15%
$56,800 - $114,650	25%
$114,650 - $174,700	28%
$174,700 - $311,950	33%
$311,950 and over	35%

The maximum tax rate on net capital gains (net long-term capital gains reduced by net short-term capital losses) has been reduced from 20 percent to 15 percent (and from 10 percent to 5 percent for taxpayers in the 10 percent and 15 percent tax rate brackets). These rates apply for both the regular tax and the alternative minimum tax.

The same 15 percent maximum tax rate that applies to net capital gains also applies to dividends paid by most domestic and foreign corporations after December 31, 2002. Certain dividends from mutual funds, real estate investment trusts and some foreign corporations do not qualify for the reduced rates. Such dividends will continue to be taxed as ordinary income.

While the rate cut on dividends falls far short of President George W. Bush’s original plan to essentially eliminate that particular tax, it is still enough to rearrange the investment landscape. Dividend-paying stocks are now far more attractive relative to corporate and Treasury bonds.

What next from Congress?

To reduce the budgeted cost of the tax changes, Congress decided that the lower rates on dividends and capital gains would expire after 2008. But the idea of taxing these investment returns more lightly than interest or wages is likely to persist, and may even receive increased emphasis.

Since significant federal government budget deficits are projected over the next ten years, the tax rates on ordinary income may eventually rise. That could increase the advantage for dividends and capital gains.

Analysis

The advantage of tax-deferred savings has disappeared in some cases and diminished in others. Investors will weigh carefully whether to lock money in a tax deferred account. With the assistance of their agents and brokers, some investors will make projections to determine the tradeoff. Some may retain a preference to defer the (certain) payment of taxes today in exchange for the (uncertain) payment of taxes in the future.

401(k) and IRA accounts postpone taxes

until retirement, but then their proceeds are taxed as ordinary income. For many taxpayers, particularly in the top brackets, it will now be more attractive to pay taxes each year on earnings at the low 15 percent rate.

Variable annuities (and variable life insurance to a lesser extent) have lost some of their attractiveness. Investors will be less willing to pay the somewhat higher fees in annuities to get the tax deferral.

The following table shows the number of years that a buyer must leave his money in a variable annuity before it catches up to direct investment in the same underlying funds, assuming that **all** the returns in the mutual funds are taxed at dividend or long-term capital gains rates (15 percent). If some of the mutual fund returns are interest or short-term gains, the number of years will shorten.

Ordinary Tax Rate	Rate of Return	Excess VA Charge	B-E Year
25%	8%	0.50%	42
28%	8%	0.50%	49
33%	8%	0.50%	61
35%	8%	0.50%	66
25%	10%	0.50%	31
28%	10%	0.50%	35
33%	10%	0.50%	43
35%	10%	0.50%	47

Ordinary Tax Rate	Rate of Return	Excess VA Charge	B-E Year
25%	8%	0.20%	27
28%	8%	0.20%	32
33%	8%	0.20%	41
35%	8%	0.20%	45
25%	10%	0.20%	26
28%	10%	0.20%	28
33%	10%	0.20%	33
35%	10%	0.20%	36

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"Excess VA Charge" in this table refers to the excess of annual fees in a variable annuity that do not attach to the underlying mutual funds. The Rate of Return shown in the table is attributed to the mutual fund, and the Rate of Return less the excess charge is attributed to the variable annuity. Both 0.20 percent and 0.50 percent are shown because opinions will differ as to the realities of the marketplace. The lower differential might be more applicable if the products are from comparable distribution systems. Another issue is whether to ascribe any value to variable annuity benefits such as the GMDB.

That most variable annuities have heavy surrender charges is less subject to debate. The effect of heavy surrender charges is the loss of a real option to the variable annuity buyer, and that is not considered in this analysis.

The variable annuity does dramatically better as the assumed rate of return increases.

Fixed annuities retain their appeal compared with interest-paying investments, except to the general extent that investors move money from investments paying interest to investments paying dividends and capital gains.

Deductible IRAs and 401(k)s, that allow an investor to save pre-tax dollars, remain excellent bargains. Those accounts may be used more for investments that would otherwise be taxed at ordinary income rates, such as bonds. Active stock traders who take frequent short-term gains, which will still be taxed as ordinary income, will do more of their trading in IRA accounts.

Insurers should continue monitoring sales practices in the tax-deferral area. Comparative analyses of tax deferral versus paying taxes each year used by agents and brokers should be re-engineered, or at least closely examined.

Product Development

Annuities may be attractive as a niche product for investing in high-yield bonds, which are otherwise currently taxed at ordinary income rates. Insurance companies might begin to emphasize high-yield bond funds within their variable annuities. Companies may try to segment the general account, so as to pay high-yield bond returns to fixed annuities. Inflation-indexed bonds will also appeal to investors concerned about that particular risk, and may provide another area for research and development.

Guaranteed Minimum Income Benefits and other variable annuity guarantees should continue to receive emphasis, since they are an attractive feature that cannot be offered by other types of investments.

A sophisticated investment strategy might be to use mutual funds to provide for years prior to the break-even year, and variable annuities to provide for years after the break-even year. Research could judge whether such an idea can lead to a useful product offering.

If these tax changes do in fact cause a reduction in assets under management by insurers, the industry will look for ways to turn the tide. An idea that is largely untried would be health insurance with a savings element. The concurrent sea changes of President Bush's tax cut and reduced health insurance coverage from employers may generate new ideas in this area. Perhaps actuaries from the health and investment sub-disciplines will combine their efforts. □

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