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Variable Annuities Look Pretty Good at Tax Time

By Scott Stolz

What You Need to Know

- Some of your clients might owe capital gains taxes despite seeing negative returns.
- Variable annuities are not subject to capital gains taxes, even when rebalancing assets among subaccounts.
- VA gains will be taxed as income when withdrawn.

Tax season is here, and so are the difficult 1099 talks with clients. Having to explain to a client that they have to pay capital gains taxes despite staring at negative 20% returns is never a fun conversation.

"Let me see if I have this straight: My investment in XYZ fund has gone from $1 million to $800,000, but I have to pay $25,000 in taxes? In what alternate reality does that make sense?" Not fun at all.

Let me offer a potential solution to this problem. What if a meaningful percentage of your client's investable assets outside of qualified retirement plans was held within a **variable annuity**?

I've had the same variable annuity for 32 years now, and do you know what I've never received? A 1099 for income taxes due. Not once. No taxes of any kind in 32 years and counting.

Yes, I will eventually pay taxes on what are now pretty substantial earnings. And yes, those taxes will be paid at the ordinary income tax rate rather than the long-term capital gains rate. But how much extra money will I have because every penny I would have had to pay in taxes over the years is still sitting in my account, compounding away?

I'm sure some of you reading this article are saying, "I have an even better idea. Rather than put my clients in mutual funds, I use **ETFs**. They aren't required to distribute capital gains each year, so they are a much more tax-efficient solution."

That would, of course, be a true statement. But is it a better solution? How many of your clients in 2022 sold some of their equity ETFs to reduce the volatility of their portfolio? How did they fare with capital gains?

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Or maybe due to the strong market performance of 2021, you rebalanced your clients' portfolios to get them more in line with their proper risk/reward profile. What were the tax consequences of that transaction? Or worse yet, did you or your client elect not to rebalance to avoid generating those capital gains? How has that plan worked out thus far?

Which brings me back to my variable annuity. Over the years, I've reallocated within the sub-accounts in my variable annuity to either invest more aggressively or take some risk off the table. But since I can do this within my contract, I have never had to worry about the tax consequences of the change. How great is that come tax time?

Now, I must admit that avoiding 1099s for over three decades was not my original goal for this contract. And since I was well below the age of 59.5 for the majority of the years I've owned the annuity — therefore making me subject to the 10% penalty on any withdrawals before that age — I didn't hold a significant percentage of my investable assets in this policy for many years. But that changed when I moved into my 50s. Rather than add to my existing mutual funds, I put new investable assets into my variable annuity.

Even after the 2022 capital gains distributions, most of your clients probably still have too much in unrealized gains to justify selling their mutual funds to reposition their assets within a variable annuity.

But perhaps you can minimize their tax problem going forward.

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If you are purchasing an annuity contract to fund an IRA or employer-sponsored retirement plan, you should understand that such annuities do not provide tax-deferral benefits beyond those already provided by the Internal Revenue Code.

Variable annuities are sold by prospectus only, which contains more complete information about the policy, including risks, charges, expenses and investment objectives. You should review the prospectus carefully before sending any money. Contact a financial professional for a copy of the current prospectus.

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