ARE 529 PLANS BETTER INVESTMENTS THAN VARIABLE ANNUITIES, EVEN IF NOT SPENT ON EDUCATION?

IF SO, WHY EVER USE A VARIABLE ANNUITY?

By: Alan S. Gassman

Most clients view 529 Plans to be appropriate planning vehicles only when all or most of the monies will be devoted solely to college and graduate school tuition and permitted expenses. At the same time, a number of financial advisors often consider variable annuities viable for facilitating the deferral of tax on income. In this article, we aim to explore whether a 529 Plan might serve a similar purpose, and in fact be preferred over a variable annuity for many clients. There are a number of advantages to using 529 Plans beyond educational funding. In many situations, 529 Plans will be preferred to variable annuities, even when educational expenses are not the primary goal.

The primary purpose of this article is to help the reader understand important tax and investment characteristics of both variable annuities and 529 Plans, and to question the wisdom of the purchase of variable annuities, while reviewing the advantages and features of 529 Plans.

1. Non-Educational Distributions from 529 Plans Carry Out Income and Basis Pro Rata; With Annuities the First Dollars Out are Taxable. Distributions from variable annuities normally carry out accumulated income first, and principal only thereafter. A client holding a $100,000 variable annuity that cost $80,000 must pay tax on the first $20,000 withdrawn. At the 43.4% tax bracket, this would cost $8,680 in combined income and Medicare taxes.

Monies withdrawn from a 529 Plan are only taxable pro rata to the income portion. In the above example, there would be tax on only $4,000 worth of income (20% of the withdrawal), so the tax would instead only be $1,736.

While it is true that the $4,000 will be taxed at the taxpayer's highest tax bracket plus an additional 10%, the excess of $20,000 ($7,920) to 53.4% of $4,000 ($2,136) is a big difference.[1]

Yes, a variable annuity might be exchanged tax-free under Internal Revenue Code Section 1035 in order to facilitate less than $20,000 of the distribution being taxable. However, this would involve a tax-free exchange into multiple separate annuity contracts and then waiting 18 months before making the withdrawal.

Alternatively, two annuity carriers that we are aware of do offer products that allow pro-rata distribution of income, if the IRS accepts this, but the vast majority of annuity companies

1 Michael Kitces co-author of the "Advisor's Guide to Annuities" provided the authors with the following comment, "Notably, there have been recent discussions in tax committees about raising the 10% penalty, specifically to dissuade people from using a 529 Plan as non-qualified accumulation vehicle."

do not offer this option. One of the exceptions is the Lincoln I4Life, where the current year's income is paid out first, and then pro rata between earnings and basis after the current year's income. Equitable/AXA has a similar product arrangement. 529 Plans are less expensive than these commercial annuities, and have other characteristics as herein described.

2. <u>529 Plans Can Continue After the Death of a Family Member</u>. Variable annuities have to be paid out within five (5) years of the death of the annuity holder, or possibly over the life expectancy of a beneficiary, with the sole exception of the above being that a surviving spouse can facilitate deferral for his or her lifetime.

With a 529 Plan, there is no distribution requirement upon death or any other event. A 529 Plan can pass from person to person and generation to generation indefinitely, and is not even limited by the rule against perpetuities, which is 365 years in Florida.[2]

3. <u>529 Plans Reward Educational Pursuits</u>. 529 Plans encourage education and limit educational living expenses to levels that are recommended by applicable colleges and universities. No tax is payable on income that would otherwise be subject to tax when 529 Plan monies are spent in this manner.

There is no such protection with annuities.

4. <u>529 Plans Can be Owned by Complex Trusts, Family Limited Partnerships, and Other Entities</u>. Variable annuities cannot be safely owned by trusts that are taxed independently from their Grantor unless the trust has special language that makes it clear that the annuity is held for the benefit of an identified individual(s), or a private letter ruling is received from the Service, if they are even willing to issue one.

Most financial advisors are not aware that upon the death of an individual annuity owner, contract ownership or other rights that pass to an irrevocable trust to be held for a spouse or descendants will probably have to be paid out within five (5) years, thus triggering all income tax. Presently irrevocable trusts are in the 39.6% income tax bracket, and are also subject to the 3.8% Medicare tax on undistributed income exceeding $12,055. Having to distribute this income to beneficiaries in lower brackets to save income tax may result in the assets being wasted by inappropriate spending, loss to creditors or spouses, or otherwise being mishandled in a way the Grantor did not intend.

Some planners suggest incorporating trust provisions similar to those required to allow a trust to spread its retirement plan distributions over the life of a trust beneficiary. Unfortunately, the IRS has refused to issue regulations to make this action safe, so effectively clients are bound by the five year rule described above.

5. <u>529 Plan Ownership Can be Transferred Without Triggering Income Taxes</u>. Income within a variable annuity contract is triggered upon transfer. If someone wants to make a

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2 The authors expect that within 365 years the rule against perpetuity will change, and regret that we will not be here in our present form to witness that.

gift of a variable annuity contract, he or she is considered to have received all income from the contract at the time of transfer. If he or she has not reached age 59 1/2, or the transferor is not an individual, then this income is taxed at the taxpayer's highest income tax bracket plus an additional 10%.

On the other hand, 529 Plan ownership can be freely transferred without triggering such taxes.

6. 529 Plans are Less Expensive to Purchase and Maintain. The median total annual costs for 529 Plans with an up-front sales commission (Front-end load) is roughly 1.14% per year, while the median total annual costs for variable annuities with a front-end load is roughly 1.67% per year.[3] The median total annual costs for 529 Plans with a contingent deferred sales charge (back-end load) is roughly 1.85% per year, while the median total annual costs for variable annuities with a back-end load is roughly 2.20% per year.[4] Hybrid index annuities that are designed to replicate market index results and avoid market index crashes are said to trail the actual market index plus dividends by 4% to 6% on average.

While there are low cost no-load annuity products that compete with 529 Plans from an expense standpoint, a great many investors do work with commissioned sales organizations, such as banks, brokerage firms, and insurance agencies, and should have access to the choices available in the commissioned product system.

A mathematical example that compares the effect of expenses on the two funds is as follows:

Clients who would like to invest with Vanguard could buy a 529 Plan, invested a growth fund, with an average annual expense charge of 0.19%.

The Vanguard variable annuity, also invested in a growth fund, will cost approximately 0.71% per year.

When you consider a possible cost savings of 0.52 % per year for 18 years, and assume 6% a year in growth, a $100,000 investment would grow to $276,364 under a 529 Plan costing 0.19% a year, and only $252,479 under a variable annuity, costing 0.71% a year; a difference of $23,885.

While a low-cost variable annuity will normally be superior if a large portion of the 529 Plan above and beyond its original cost basis is not spent on educational expense, 529 Plans still have the other advantages described above and below. It is noteworthy that a loaded annuity

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3The approximate median total cost was computed from a list of available front-loaded 529 Plans and variable annuities.

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contract compared to a loaded 529 Plan may have a less favorable result, and a 529 plan could be superior even after the application of the excise tax at the highest tax bracket.5

It is of note that 529 Plans do have limits on the amount of assets that can be contributed on behalf of each designated beneficiary. These amounts vary among the states, but are typically limited to amounts that are necessary to finance the designated beneficiary's educational expenses. For example a 529 Plan offered through Vanguard imposes contribution limits of $370,000.

7. Five Year Forward Averaging of 529 Plan Gifts. Clients who wish to make gifts using 529 Plan funding can elect to have 80% of the amount transferred considered to have been gifted in the four years subsequent to the 529 Plan funding to maximize use of the $14,000 per person per year annual gift tax exclusion. For example, a $70,000 contribution to a 529 Plan for a grandchild can be considered to be a $14,000 gift in the year of contribution, and in each of the four subsequent years. If the donor dies before the beginning of the fifth year then the applicable portion of the unapplied gift will be considered an asset of the donor's estate for estate tax purposes, assuming that the donor will be estate taxable with such addition.

A gift that is used to purchase a variable annuity will be considered to have been made 100% in the year of purchase.

It is noteworthy that monies paid directly for tuition are not counted as gifts under the federal estate and gift tax law, but monies put into a 529 Plan that is eventually used to pay tuition will be considered to be gifts, but will use a part of a person's $5,340,000 estate tax exemption amount if and when exceeding $14,000 a year. Simple low cost passive mutual funds which have very little income, and generate qualified dividends and capital gains which are taxed at the 20% bracket (plus a possible 3.8% for Medicare tax, when applicable), may therefore be preferred over 529 Plans, at least for monies to be paid for tuition.

5A separate question is whether it is worthwhile paying a commission. In some cases it may be if the sales person provides valuable service and guidance in exchange for the commission. In other cases it may be a waste of money. The same can be said for advisors who charge a fee. Some provide valuable service and advice in exchange for their fee. Other advisors give lip service to service and guidance and the fee is as much of a waste as a commission.

8. In Some States 529 Plans Are Protected from Creditors, But Variable Annuities Are Not. Many states provide protection for all 529 Plans and variable annuities, and some states provide protection for 529 Plans, but not for variable annuities, or only for variable annuities to the extent deemed reasonably necessary to provide for the retirement needs of the owner. A few states, like Colorado, Virginia and West Virginia, provide creditor protection for 529 Plans, but not variable annuities.

9. Widely Criticized Investment Aspects Found in Certain Variable Annuities Are Not Permitted in 529 Plans. Many investors have been disappointed to learn that "guaranteed income benefit features" and "equity index guaranties" that were explained to induce the purchase of variable annuities have turned out to have been not as expected, and much more expensive than understood. State and federal regulation associated with 529 Plan investments and disclosures do not permit these or certain other features that most conservative investors and investment advisors find to be expensive and generally undesirable for the vast majority of clients. *See* Alan S. Gassman *Evaluating Commercial Annuities and Reverse Mortgages: Are Deferred Payment Annuities too Good to be True?*

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