Getting the Exclusion Ratio (Without Annuitizing)

By Kerry Pechter *Wed, Jun 25, 2014*

AXA and, most recently, Lincoln Financial, are marketing variable annuities that combine investment flexibility with variable income options that (for non-qualified contracts) allow regular tax-favored distributions without annuitization.

Thirty-some years ago, the IRS decided to change the tax treatment of partial withdrawals from non-qualified deferred variable annuities from FIFO (first-in-first-out) to LIFO (last-in-first-out). Unless they annuitized, generally, the owners of contracts issued after August 13, 1982 have had to withdraw all of their taxable gains before they could withdraw any of their after-tax principal.

If they annuitized, they could withdraw a blend of gains and principal, and exclude the return-of-principal portion from their taxable income. Annuitization was thus a way to spread the tax on the accumulated gains over a person's remaining lifetime.

There was a method to the IRS' madness. It wanted to reserve the tax advantages of deferred annuity contracts to long-term investors (especially those seeking retirement income security) and to frustrate the merry pranksters who were using VAs to shelter the gains on freely-withdrawable short-term investments.

But at least two large annuity manufacturers—Lincoln Financial in 2000 and, more recently, AXA—have obtained private letter rulings from the IRS that allow some of their VA clients to get the exclusion ratio without formally annuitizing. What's newsworthy is that this feature is being combined with the sale of new VA contracts that are being marketed for tax-advantaged investing.

Investor Advantage

Last month, Lincoln Financial introduced the Investor Advantage contract, thus joining the trend, started by Jackson National's Elite Access, of appealing to investors who want tax-deferred investing in an almost unconstrained range of funds, including alternatives. Investor Advantage offers 125 fund options—significantly more than the number offered in Lincoln's popular ChoicePlus VA suite of contracts.

If and when owners of Investor Advantage want to draw down those assets tax-efficiently (but without annuitizing), they can opt for Lincoln's long-standing patented i4Life Advantage income rider. During this rider's "Access Period," which must be at least five years in length and can last to at least age 115 for non-qualified owners, the owner can receive regular variable payments with an exclusion ratio—while maintaining access to the assets.

The Access Period of Lincoln's i4Life Advantage can be thought of as the term-certain portion of a life-with-period-certain contract, with variable payments, according to Dan Herr, vice president of annuity product management at Lincoln Financial.

The cost of Lincoln's Investor Advantage contract is 1.50%, which includes the M&E, administrative charge and 40 basis points for the i4Life Advantage rider. Contract owners don't pay the rider fee unless or until they turn on the rider.

Lincoln does bear mortality risk, because at the end of the Access Period, the remaining account value converts into a life-only income annuity with variable payments. But Lincoln doesn't bear investment risk, because the payouts fluctuate with the markets.

Investment Edge

Only about eight months old is AXA's Investment Edge, which offers a rider called Income Edge. This rider, which carries no added cost and is available only on non-qualified contracts worth at least $25,000, allows contract owners to withdraw their money over a fixed number of years while enjoying the exclusion ratio and retaining the option to take lump sum redemptions.

The income period can range from 10 years to as many as 30 years or more. After the payments begin, the owner can still redeem part or all of the account value. Those redemptions are fully taxable as ordinary income.

AXA sought and obtained an IRS private letter ruling (PLR) for Investment Edge in mid-2013 and got verbal approval before year-end. (The IRS posted the PLR on its website this month. Lincoln obtained its own private letter ruling over a decade ago when it created i4Life Advantage.) AXA's PLR describes the rider as a "term certain annuity option with variable payments."

The AXA Investment Edge prospectus offers an example of how Income Edge might work. If an 80-year-old contract owner—that's the oldest age permitted for a 15-year payout period—elected to receive variable income over 15 years from a contract valued at $150,000, he or she would receive $10,000 the first year or one fifteenth of the account value. At the start of each succeeding contract year, the account value would be divided by 14, 13 and so on, to calculate the annual payout.

The B-share of AXA's Investment Edge carries annual separate account fees of 1.20%. There is no specified mortality & expense risk fee or income rider fee; AXA bears neither market risk nor mortality risk. Fund fees, of course, are extra.

As befits investment-oriented annuities, both of these contracts offer lots of funds, including trendy alternative investments, including real estate, commodities and emerging market debt. Most investors don't understand alternatives, but advisors seem to think they offer a chance for higher returns and greater diversification at a time when yields are low and non-correlated investments can be hard to identify.

In addition to the funds offered by other Lincoln contracts, Investor Advantage offers funds from AQR, First Trust Portfolios, Goldman Sachs Asset Management, and Ivy Funds. AXA Investment Edge offers over 100 funds, including three Alternative funds from AXA's Charter Portfolios.

Depending on the success of these two products, and the IRS' apparently willingness to bless the tax treatment of the payouts, we could see more of this type of contract. They are designed for relatively younger retirement savers who want to invest actively in mutual funds on a tax-deferred basis and who, when the time comes to take income, may like the exclusion ratio and be able to tolerate the fluctuating payments.

Although several annuity issuers are using anxiety over potentially rising federal tax rates to generate interest in VAs that offer tax-deferred trading, manufacturers have other reasons for promoting them. They're cheaper and safer to issue than VAs with guaranteed lifetime withdrawal benefits, which helps manufacturers increase capacity without going up in cost or capital requirements. Either way, the addition of a low-cost income solution could very well broaden their appeal.