

# How Do You Spell Relief: T-E-N - T-H-I-R-T-Y - F-I-V-E

Transferring to a lower-cost variable annuity via a section 1035 tax-free exchange

## Overview

As of year-end 2001, investors had tucked away more than \$825 billion into variable annuities<sup>1</sup>, with much of those dollars potentially sitting inside contracts with expenses that may be higher than necessary. The good news for investors seemingly stuck with higher-cost variable annuities is they need not suffer with “buyer’s remorse,” as the Internal Revenue Code (IRC) offers potential income tax relief under section 1035.

IRC section 1035 allows for the “like-kind” exchange of one annuity (fixed or variable, provided annuitization has not begun) or life insurance contract for another, even between different insurance carriers, without any current income taxation. Thus, investors need not be saddled with high-cost variable annuities for fear of negative income tax consequences. The Schwab Center for Investment Research studied the factors surrounding a section 1035 exchange. Following is a discussion of our findings, which include the potential benefits of exchanging a higher-cost variable annuity product for a lower-cost, no-load variable annuity product (assuming equal investment performance), as well as the rules and mechanics surrounding such an exchange.

## Key Findings

- In the absence of surrender charges, and all else being equal, investors with higher-cost variable annuities should consider transferring to variable annuities with lower costs.
- The presence of surrender charges could be an obstacle to a cost-effective exchange. Surrender charges in and of themselves, however, shouldn’t necessarily keep investors from exchanging to a lower-cost VA. Depending on the size of the surrender charge relative to the anticipated cost savings, and the time interval until the next change in surrender charges, investors may still benefit from a 1035 exchange. They should do so only after performing a detailed analysis based on their specific facts and circumstances, using reasonable assumptions.
- Exchanging more than one VA in a single year could negatively impact an investor’s taxes.

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<sup>1</sup> Source: Strategic Insight Overview, Issue 3, 2002.

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### Why change?

Investors everywhere seek to have some degree of control over their investments' performance. Yet, despite our best intentions, we are still subject to broad market fluctuations over the short term. In the process of structuring our investment portfolios, however, we shouldn't subject ourselves to excess income taxes and/or expenses for any period of time if we can help it, as the impact of income taxes and expenses on overall investment performance can be significant. After all, it is not what we make but what we keep that ultimately matters. While variable annuities may help investors take control over their income tax situation, high expenses could erode the tax benefits. Ideally, investors should seek both tax efficiency and low expenses when possible.

There may be several reasons for considering a 1035 exchange aside from expenses alone, including: performance of underlying investment choices, flexibility of the contract, credit quality of the insurance company issuing the contract, available features and benefits. Assuming investment options, performance, and credit quality are equal or similar under one variable annuity plan vs. another, the three main factors investors contemplating a 1035 exchange should consider are income taxes, annual expenses, and surrender charges (deferred load/sales charges).

### Variable Annuities & Income Taxes

#### A Brief Overview

Contributions to variable annuities (outside of qualified retirement plans) are not tax-deductible, but earnings do grow tax-deferred until withdrawal. As with qualified employer plans and IRAs, there is a 10% federal penalty (plus penalty at the state level, if applicable) for early withdrawal from a variable annuity prior to age 59½. Unlike qualified employer plans and IRAs, investors aren't required to start withdrawing from VAs at age 70½.

Distributions from variable annuities categorized as earnings are treated as ordinary income for income tax purposes, regardless of how the earnings

were derived (i.e., interest, dividends or capital appreciation). The actual income tax treatment of distributions from a variable annuity, however, may vary based on the type of distribution (surrender vs. annuitization) and the date in which the annuity contract was entered.

In the context of making a 1035 exchange, it's important to take a closer look at taxation of partial and full surrenders of the annuity contract:

#### Partial Surrender

Annuities purchased prior to August 14, 1982 (IRC section 72) operate under the FIFO (first-in-first-out) rule. A partial surrender under this rule means the withdrawal is treated as having come first from the cost basis in the contract. Once the cost basis is exhausted, the remainder is treated as ordinary income.

For annuities purchased after August 13, 1982, the partial surrender is taxed on a LIFO (last-in-first-out) basis, meaning that the withdrawal is treated as having come first from earnings and is therefore fully taxable up to the point where the cost basis is reached.

#### Full Surrender

In the case of a full surrender, the income tax treatment is straightforward: the cost basis in the contract is received tax-free and all earnings are taxed at the ordinary income rate.

Income taxes are not an obstacle to investors wishing to exchange annuities when the annuity has declined in value relative to the cost basis in the contract. This is because the full surrender would be deemed a return of investment (although investors may lose any potential death benefits by transferring an annuity with enhanced death benefit features under such circumstances). Income taxes, however, could present an obstacle to investors wishing to get out of an existing variable annuity contract when the annuity has untaxed earnings. A tax-free exchange under section 1035 removes this potential income tax obstacle.

### Tax Trap for the Unwary

The Internal Revenue Code may give it, but it also takes it away. While IRC section 1035 provides significant relief for investors seeking to exchange a high-cost annuity for a low-cost one, IRC section 72 governing annuity contracts has its own set of rules. IRC 72(e)(11)(A)(ii) says, "...all annuity contracts issued by the same company to the same policyholder during any calendar year shall be treated as 1 annuity contract." This means that if you exchange more than one variable annuity contract to the same new provider in a single year under a 1035 exchange, the new contracts will be treated as a single annuity for income tax purposes, even if the old annuities originally were purchased in separate years and/or from separate providers. Under 72(e)(11), negative income tax consequences could result from the resulting aggregation of cost bases when withdrawals commence.

#### Hypothetical Example\* A—Tax Trap

Alice purchased two separate variable annuities in 1996 and 1997. In 2002, she decided to exchange these annuities to a new lower-cost provider under IRC section 1035. The cost basis and current value before the exchanges were as follows:

	Cost Basis	Current value
VA 1	\$300,000	\$450,000
VA 2	\$225,000	\$300,000

Since she exchanged both contracts in the same year, she now has a combined cost basis of \$525,000 for income tax purposes. If Alice takes out \$125,000 at this point, it will all be fully taxable as she now has \$225,000 of combined earnings (\$750,000 current value—\$525,000 cost basis). However, if Alice had exchanged one contract in 2002 and one contract in 2003, the separate annuities would retain their individual cost basis characteristics. In that case, she could take out the \$125,000 from VA 2 and only \$75,000 would be taxable while \$50,000 would be deemed a return of cost basis. The lesson? Be aware the tax rules surrounding annuities can be complex, which is why you should always consult your CPA or professional income tax advisor about your individual situation.

\*All examples are hypothetical only.

### Expenses

Ongoing variable annuity expenses (aside from surrender charges, discussed later) include mortality and expense risk charges (M&E), administrative fees, underlying sub-account expenses, and fees or charges for other features. These fees could add up quickly and have the potential to significantly erode investment performance over time. Ongoing expenses could range between 2-3 percent per year, on top of loads and commissions. It's always wise to shop around, comparing products with higher expenses to available no-load, lower-cost options. You may be able to save one percent or more per year without having to incur new loads or commissions in the process. How significant is a 1-to-1.5% savings? The impact can be very significant over time.

#### Hypothetical Example B – Expenses

Bob currently owns a variable annuity with total annual expenses of 2.75%. He is able to exchange his current variable annuity for one charging only 1.5% in total expenses per year without incurring any penalty or current income taxation under IRC section 1035, but wants to know just how much he could save by doing so. How much can Bob potentially save by taking advantage of section 1035?

Current Value:	\$600,000
Hypothetical rate of return:	6.0% (BOTH old and new)
Current annual expense:	2.75%
New annual expense:	1.5%

#### Future Value:

Holding Period	Old	New	Difference
5 years	\$704,047	\$747,709	\$43,662
10 years	\$826,137	\$931,782	\$105,645
15 years	\$969,398	\$1,161,169	\$191,771
20 years	\$1,137,503	\$1,447,028	\$309,525

### Surrender Charges

If you make a withdrawal from some variable annuities within a pre-set period of time after purchase, you may incur a surrender charge. Typically, the surrender charge is set as a percentage of the amount withdrawn. The percentage rate usually declines gradually over the pre-set surrender charge period.

For example, surrender charges could be as high as 9% in the initial year and may gradually decline to zero over a period of seven-to-ten years. An investor's decision to surrender an existing variable annuity in exchange for a new contract should be based on his or her unique circumstances.

When evaluating surrender charges, the decision to make the 1035 exchange will likely depend on the current charge, the cut-off date for the next change in surrender charges, and the potential ongoing savings resulting from lower annual expenses associated with the new variable annuity contract. Let's take another look at our hypothetical investor, Bob. This time we factor in a surrender charge of 2%.

#### Hypothetical Example C – Surrender Charges

Bob currently owns a variable annuity with total annual expenses of 2.75%. He is able to exchange his current variable annuity for one charging only 1.5% per year without incurring any penalty or current income taxation under IRC section 1035, but will incur a surrender charge of two percent. Should Bob make the exchange?

Current Value:	\$600,000
Hypothetical rate of return:	6.0% (BOTH old and new)
Current annual expense:	2.75%
Surrender charge:	2.0%
New annual expense:	1.5%

#### Future Value:

Holding Period	Old	New	Difference
1 year	\$619,500	\$614,460	(\$5,040)
1.7 years	\$633,097	\$633,097	\$0
5 years	\$704,047	\$732,755	\$28,708
10 years	\$826,137	\$913,146	\$87,009
15 years	\$969,398	\$1,137,946	\$168,548
20 years	\$1,137,503	\$1,418,088	\$280,585

Critical to the surrender charge analysis is the "breakeven" point at which the investor is better off with the new contract. In Bob's case above, the breakeven point is 1.7 years. If he executes the 1035 exchange now, his breakeven point will be 1.7 years from now, assuming investment performance is equal.

But what if the surrender charge is set to drop to 1% one year from now and 0% two years from now, on the anniversary date of the contract? Does it make sense to wait?

#### Hypothetical Example D – Surrender Charges

The table below, which uses the same expenses and expected rate of return as were used in Hypothetical Example C, compares the future value 20 years from today under the following three scenarios:

1. Exchange today (hypothetical \$600,000 current value with a 2% surrender charge),
2. Exchange in one year (hypothetical projected value of \$619,000 at the time of the exchange with a 1% surrender charge), and
3. Exchange in two years (hypothetical projected value of \$639,634 at the time of the exchange with no surrender charge).

#### IT MIGHT NOT MAKE SENSE TO WAIT\*

Exchange:	1. 2% charge	2. 1% charge	3. 0% charge
Today	\$600,000		
1 Year		\$619,500	
2 Years			\$639,634
<b>Future Value:</b>			
20 Years	\$1,418,088	\$1,415,422	\$1,412,618

\* Illustration assumes hypothetical 6% investment return is equal between old and new.

When you compare all of the hypothetical projected values at 20 years for the new annuity above with that of the old annuity (\$1,137,503 - see previous Hypothetical examples), as well as the diminished potential values connected to waiting for a lower surrender charge before making the exchange, you see the potential advantage of making the 1035 exchange today. But, what if the surrender charge on the old annuity was set to drop to 1% six months from now (hypothetical projected value at that time of \$609,672) instead of in one year?

#### WAITING SIX MONTHS MIGHT MAKE SENSE

Exchange:	2% charge	1% charge	1% charge	0% charge
Today	\$600,000			
6 Months		\$609,672		
1 Year			\$619,500	
2 Years				\$639,634
<b>Future Value:</b>				
20 Years	\$1,418,088	\$1,423,964	\$1,415,422	\$1,412,618

(continued from page 4)

In the case above, assuming equal performance, it might make sense to wait the six months assuming the surrender charge drops to 1% at that point in time.

Importantly, these tables show that each situation must be evaluated based on the unique set of facts and assumptions to determine whether it is potentially advantageous to make the 1035 exchange immediately, or to wait.

Following is a table showing the number of years it may take to reach the breakeven point when surrender charges are present, depending on the surrender charge in place and the potential savings in annual expenses (assuming all else is equal). The surrender charge is on the vertical axis and the corresponding expense ratio reduction falls on the horizontal axis. Where the two points meet in the table is the breakeven point. For example, the breakeven point for an investor with a current surrender charge of 1% and a potential expense savings of 2% is 6 months. Unless the surrender charge is set to go to zero over the next six months in such a case and, again, assuming investment performance and all else is equal, there would be no reason to wait.

MONTHS TO POTENTIAL BREAKEVEN*				
Surrender charge	1%	13	8	6
	2%	25	17	13
	3%	38	25	19
	4%	51	34	25
	5%	64	43	32
	6%	77	51	38
		1%	1.5%	2%
Expense savings				

\*Months to potential breakeven are rounded up and assume investment performance is equal.

## Conclusion

As savvy investors, we have the ability to take some control over future performance by focusing on asset allocation, diversification, and on structuring our investment portfolios in the most tax-efficient, cost-effective way practical. It seems reasonable that whenever we are able to exercise the greatest degree of control in the important areas of income taxes and expenses we should consider doing so. In the case of variable annuities, a section 1035 exchange can be an easy and practical way to take such control over the future performance of our investments.

Before investing in a variable annuity, a prospectus should be obtained and read carefully. Call Schwab at 1-800-435-4000 to obtain one. Also, a person should be appropriately licensed and appointed in order to discuss specific annuities. This analysis has considered the applicable provisions of the Internal Revenue Code of 1986, as amended, the regulations thereunder, and judicial and administrative interpretations thereof, which are subject to change or modification, either prospectively or retroactively, by subsequent legislative, regulatory, administrative, or judicial decisions. The information and content provided herein is general in nature and is for informational purposes only. It is not intended, and should not be construed, as a specific recommendation, or legal, tax, or investment advice, or a legal opinion. Individuals should contact their own professional tax advisors or other professionals to help answer questions about specific situations or needs prior to taking any action based upon this information.

The author wishes to thank the following people for their contributions: Mark Riepe, James Peterson and Darryl Forman.

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