

PLANNER

IDEAS FROM LEADING EXPERTS IN FINANCIAL PLANNING

TRENDWATCH

The U.S. Treasury plans to issue bonds indexed to inflation. The bonds would be *bullet bonds*, which are similar to regular Treasury bonds, but zero-coupon bonds and amortization bonds may be issued as well. Denominations will be as low as \$1,000. The issues relating to the proposal that need to be resolved include:

1. **The maturity of the bonds.** The treasury is considering 10-year and 30-year bonds, but is still undecided.

2. **The "real" interest rate.** The Treasury estimated a 3-percent rate, but the real rate will be determined by what buyers demand. It is expected that the real rate will fluctuate with investors' fears about inflation. When inflation fears are high, investors will buy the bonds at a low rate, but when fears are low, they will demand a higher real rate to assure a good return.

3. **The inflation index.** The Treasury does not yet know what inflation index to use. Possibilities include the Consumer Price Index, or the "core" index, which excludes changes in food and energy prices; an index of wage costs; the inflation rate measure in the gross domestic product calculations; or a combination of indexes.

4. **The probable buyers.** The Treasury hopes that individual investors, as well as institutions will buy the bonds. Mutual funds will probably be created to invest in these bonds.

5. **Impact on the stock and bond**

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Living Trusts: Who Really Needs Them?

By Phyllis J. Bernstein

Phyllis J. Bernstein, CPA, Director of the AICPA Personal Financial Planning Team, describes how living trusts work and compares their benefits and disadvantages.

Many people think the living trust is the estate planning strategy that will resolve all estate planning problems. Living trusts are aggressively marketed in free seminars, advertisements and mass mailings, but they involve some costs and they are not right for everyone. If they are improperly used, they can cause some unintended results.

What is a Living Trust?

A living trust, also known as an inter vivos trust, takes effect when it is estab-

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Index Funds Offer Tax Advantages Over Variable Annuities

By Lou Barberini

Lou Barberini, CPA, PFS, practices in San Francisco. In this article, he asserts that index funds offer investors many of the advantages they seek—but may not actually get—by investing in variable annuities.

Variable annuities are very attractive. Many investors think of them as clones of famous mutual funds, using them to defer income tax on dividends and appreciation. Yet, in 1995, despite a robust equities market and swelling mutual fund assets, sales of variable annuities of \$50

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billion in 1994 remained flat in 1995. Perhaps, the slowdown in sales can be accounted for by investors learning about the negative tax consequences of variable annuities and the advantages of equity index fund assets.

Variable annuities have two distinct advantages:

1. Dividends and gains are tax deferred.
2. The tax consequences of switching between subaccounts (funds) are deferred until the annuity is liquidated.

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TRENDWATCH

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markets. Inflation-indexed bonds could divert money from the equity market because individuals investing for retirement may believe that they could be guaranteed a real return without the risks of the stock market. The proposed bonds could expand the demand for bonds, which, in turn, could result in lower interest rates. But, since the bond market is very large, that effect is uncertain.

6. Tax. Like any Treasury bonds, the twice yearly interest payments are ordinary income. Furthermore, every six months, the principal value of the bond would rise, so the investor would owe tax at ordinary rates on the gain. An investor who sells a bond before maturity would have a capital gain or loss based on the cost of the bond and any increases in principal value. It is expected that many investors will choose to own bonds that are held in tax-deferred accounts, such as individual retirement accounts or 401(k) plans, and therefore will not be taxed until the money is taken out. *New York Times*, May 17, 1996, p. D4.

Trading on the Internet. Trading on-line is spreading as other brokers follow the lead of Charles Schwab, which launched a World Wide Web-based pilot program for on-line trading in March. Schwab is the first major brokerage to trust the Web's security. Online investing is only a small part of the investment world. At present, there are approximately 800,000 online brokerage accounts, or one for every hundred traditional

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Index Funds Offer Tax Advantages Over Variable Annuities

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The attractiveness of these two advantages of variable annuities seem to be fading. For one reason, stock dividend yields are at record lows. Consequently, the dividend portion of the variable annuity deferral is greatly reduced. Secondly, despite having many investment options, variable annuities are not structured to provide investors with the same flexibility they would have if they diversified among different mutual fund families.

Variable annuity investors can switch among the funds offered within their variable annuity, but if investors want to diversify a portion of their present annuity to a "hot" technology manager at another variable annuity company, they are out of luck. Section 1035 of the Internal Revenue Code allows transfers of entire annuities, but precludes partial transfers. Therefore, although much publicized, the advantage of having the flexibility of switching between annuity investment funds without incurring taxes is limited to investors' existing annuity company sub-accounts.

Despite current low dividend yields, approximately 2 percent on the Standard & Poor 500 Index, many sophisticated investors are choosing index funds as a tax advantaged alternative to variable annuities. Index funds are "auto-pilot" mutual funds structured to parallel market indexes such as the S&P 500. The Fund's dividends are taxable as ordinary income, and portfolio adjustments trigger the capital gains tax.

How then can these taxable index funds offer tax advantages superior to the tax deferral feature of variable annuities? Variable annuities are not considered capital assets. Income from them is eventual-

ly taxed as ordinary income, not at the lower capital gains rate.

Advantages of Index Funds

As "auto-pilot" mutual funds, index funds require very little hands-on management, which translates into cost savings to investors through minimal management fees. Furthermore, brokerage commissions and reported capital gains are lower because there is less asset shifting within the index fund.

Index funds are passive in nature. Consequently, most appreciation in index funds is naturally tax deferred until liquidation, just as it is in annuities.

Under current law, index funds are characterized as capital assets. They therefore have the advantage that when they are liquidated, appreciation is recognized at the more favorable capital gains rate. In contrast, when an annuity is liquidated, the investor's appreciation is taxed at higher ordinary income rates. If an investor holds an index fund until he or she dies, his or her heirs receive a "step-up-in-basis" to the value of the mutual fund at the time the investor dies. This has the effect of eliminating from the heir's tax liability, all of the appreciation during the investor's lifetime.

Under the same circumstances, when an heir liquidates an inherited annuity, the decedent's lifetime of appreciation is subject to tax at ordinary income tax rates. Thus, annuities convert property subject to capital gains taxes (for example, stocks and bonds) into property subject to ordinary income taxes. At death, a tax is created that would not have been imposed if those same assets were held in the form of a mutual fund.

Index funds, as mutual funds, are more

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flexible than variable annuities in other ways. Because variable annuities are considered retirement vehicles, any appreciation withdrawn from a variable annuity before an investor turns 59½ years of age, is subject to an IRS penalty of 10 percent. This penalty is not imposed on mutual fund liquidations. Additionally, when mutual fund investors liquidate shares, they can specify that they are liquidating specific shares, ideally the shares with the highest original cost basis. By using this identification method, mutual fund investors can control the timing of when they recognize a portion of their capital gains. Mutual fund investors are never taxed on 100 percent of liquidated dollars because the gross sales proceeds are always reduced by the return of principal (the original cost of shares purchased).

The first liquidated dollars coming out of variable annuities, however, are deemed appreciation, 100 percent of which is subject to ordinary income tax rates without a reduction for the cost of shares sold. When all of the annuity appreciation is liquidated and taxed, annuity investors then can recognize the remaining liquidated dollars as a nontaxable return of original principal.

If investors want to liquidate part of their investment after a market decline and sell mutual fund shares at a loss, they get to recognize an immediately tax-deductible capital loss. Annuity investors, however, can not recognize a loss. They must liquidate their entire annuity before a loss can be incurred.

Annuity Insurance

Sellers of variable annuities may argue that, unlike mutual funds, variable annuities have an insurance feature. The annuity insurance is paid only if the investor dies. The heirs then will receive at least the original principal. Some annuities guarantee the original principal plus a 5 percent annual return. The annuity insurance costs the average investor approximately 1 percent of assets each year.

If an investor is entering an annuity as a long-term investment, is it really necessary to insure the original principal? Would that investor purchase a home for \$250,000 and pay \$2,500 (1 percent of \$250,000) this year to insure that his or

her heirs can sell the home for the original purchase price upon his or her death? In ten years when the home's value has increased perhaps to \$350,000, would the investor want to pay \$3,500 (1 percent of \$350,000) to guarantee that heirs can sell the home for the original \$250,000? Investors in variable annuities do pay these fees.

The tax pitfalls and hidden costs of variable annuities are staggering. Consequently, annuity sales are flat while investment dollars are flooding into index mutual funds. The granddaddy of index funds, the Vanguard Index 500 fund, for example, was structured to parallel the Standard & Poor 500 Index. In 1995, the Vanguard Index 500 fund achieved a 37.4 percent total return, .1 percent less than the actual S&P 500 index, and in the process attracted \$7.76 billion in new investor money. This represents an increase of 81 percent in size in one year, making it the fourth largest U. S. mutual fund and the largest index fund. The \$7.76 billion cash inflow was second in dollars to only Fidelity Magellan's \$17.2 billion in new assets. In 1995, the Vanguard Index 500 attracted 15 percent of the amount invested in all insurance variable annuities.

Although no-load investment portfolios are available through some variable annuities, in most instances, commissions for annuities' marketers range from 4 percent to 6 percent. Unlike mutual funds, in which a load-fund's entry commission percentage is reduced (break-points) based on the size of the investment, the commission on an annuity is constant. For example, a 4 percent commission on a \$5,000 mutual fund investment might

decline to a 1 percent commission on a million dollar investment whereas a 6 percent commission on a \$100,000 annuity will be the same 6 percent rate on a \$1 million investment.

Annuity commissions are invisible to investors, hidden in surrender charges (penalties for early withdrawals). With lucrative commissions concealed, variable annuities are sometimes improperly marketed as "no-load" investments, making them easier to sell compared with a load mutual fund.

The Vanguard Index 500 fund, for example, is a no-load fund. This means there is no incentive for financial counselors to recommend the fund. Despite this lack of incentive, sales of index funds are growing while sales of annuities are stagnant. ♦

Practice Pointers: Practitioners can best assist their clients by helping them keep their investing simple. If they buy quality stocks or mutual funds and hold on to them as long as possible, investors save on commissions and capital gains, reduce the chances of mis-timing the market and reap the wonderful benefits of compounding. Variable annuities may not provide these benefits.

What can the practitioner do for a client who has invested in variable annuities? Advise the client about the two drawbacks to getting out of a variable annuity: a large "ordinary income" taxable gain and a surrender charge. To get around the taxable gain, try to help the investor gradually liquidate the variable annuity.

The surrender charge is more difficult to get around. Insurance companies are often inflexible on this issue. An investor in stocks or a mutual fund may get a waiver by claiming "lack of suitability." Insurance companies, however, will stand by the contract unless the investor can prove "misrepresentation" by the agent. Advise the investor who inquires about variable annuities of these potential pitfalls.

✓ Counterpoint

Investors may have some pivotal reasons for purchasing variable annuities. They include:

- Retirement benefits are protected from creditors.
- Unlike qualified plans, there are no limits on the amounts that can be purchased.

Retirement Savers, Check Your 401(k) Math

Future taxes are key when weighing a Roth option

Imagine a savings vehicle that allows you, in retirement, to withdraw as much or as little as you wish—tax-free.

This vehicle, the Roth 401(k), is a great tool for many savers, as my colleague Laura Saunders has pointed out. Why don't more people take advantage of it?

The likely culprits are the inertia and myopia of savers and retirement-plan providers—as well as a possible conflict of interest at investment firms that are supposed to put their clients first. (A regulation the Securities and Exchange Commission introduced this past week to make brokers act in clients' best interest would do nothing to mitigate this kind of conflict.) As usual, the obstacles to building wealth are rooted in psychology and hidden incentives.

Seventy percent of corporate retirement plans offered Roth 401(k)s in 2017—just under twice the percentage a decade earlier, according to the Plan Sponsor Council of America. Yet employees participate at a much lower rate: Only 20% of workers with access to a Roth 401(k) contributed in 2017, even though 79% made pre-

tax contributions to their plans.

Employees' pretax allocations to a traditional 401(k) reduce their reported income by coming out of their paychecks before Uncle Sam can sink his meathooks into the money. So people saving for retirement regard the traditional 401(k) as a good deal. Once they are retired, though, money withdrawn from a traditional 401(k) is generally taxed as ordinary income.

Contributions to a Roth 401(k) are made from after-tax income. So they reduce your take-home pay without lowering your current tax bill.

That doesn't feel good in the here-and-now, so employers often don't push it on their workers. However, because the government took its cut before the money went in, withdrawals from a Roth are tax-free in retirement.

Unlike with a Roth individual retirement account, there are no income limits on participation in a Roth 401(k). Contributions to a Roth and traditional 401(k) combined can't exceed \$19,000 in 2019 (or \$25,000 if you are 50 or older).

For savers who don't expect to be in a significantly lower marginal tax bracket in retirement, Roths



How valid are those assumptions? Although people may well earn lower income in retirement than when they were working full time, they often don't end up in a significantly lower tax bracket, says Joel Dickson, a tax and investment strategist at Vanguard Group.

Taxpayers over age 65 are averaging \$89,750 of total income in 2019, only about \$10,000 less than the average for all taxpayers, according to Eric Toder, co-director of the Urban-Brookings Tax Policy Center.

Even so, numerous online calculators assume you will land in a much lower tax bracket after you retire.

Voya Financial Inc. and AIG Retirement Services are among the leading retirement-plan providers whose calculators default to a 25% current tax rate and a 15% tax rate in retirement (although those federal brackets haven't existed since 2017). Many smaller firms do the same.

Lou Barberini, an accountant and retirement-plan analyst at NICH Capital Partners LLC, an investment-advisory firm in La Quinta, Calif., points out a possible motive for the way these calculators are designed: Asset managers earn higher fees on larger balances. Contributions of \$10,000, pretax, to a traditional 401(k) are the equivalent of \$7,600 to a Roth if you're in the 24% federal tax bracket; state income taxes would further shrink the Roth amount.

The calculators do allow savers to change the pre-supplied tax rates, and they aren't the only information these firms provide. Still, "there may be some steering going on here," says Mr. Barberini. "They make more money on traditional 401(k)s, so it behooves them not to disclose that the Roth may be better."

"That doesn't even enter into the equation," says Charlie Nelson, chief executive of retirement and employee benefits for Voya Financial. "Our focus first and foremost is to get people to save and invest. I'm happy whether a participant is in a Roth or a traditional 401(k)."

AIG Retirement Services disputes the notion that it has a conflict. Its primary goal is to get people to "save as much as they can," says a spokesman. The firms say they will be updating the tax brackets.

If your employer offers a Roth, check the assumptions from the plan's manager. If you're being pushed to presume that your tax rate will be much lower in retirement, try the comparison using only a slightly lower rate.

Chances are, a small change will make a big difference in how attractive the Roth looks.