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9 Reasons You Need To Avoid Variable Annuities

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Suze Orman doesn't like them. Some journalists are suspicious of them. Fee-only financial advisors generally avoid them. I believe the public generally gets ripped off when they buy them. What are we talking about? Variable annuities.

But can you guess who loves variable annuities? Folks who earn sizzling commissions selling them. A 7-8% commission split with a firm still yields a tidy 3-4% commission for the seller. That's $7,500-$10,000 on a $250,000 annuity – often with very little time or effort.

Advisors and agents emit howls of protest when criticized for pushing variable annuities but there are few things more lucrative as selling a variable annuity. Caveat emptor ("buyer beware") doesn't seem to apply since sales continue to grow: +16% in 2011 to $85 billion. Advertisements that prey on retirement fears (a gorilla on a plane, elevator or elsewhere – the perils of ignoring your retirement) are very effective in tapping fears about outliving assets in retirement.

I regularly receive emails from annuity firms who promise substantial commissions for selling annuities (note: they don't know I don't sell products). My 84 year old father is a great example of a potential variable annuity victim – a financial advisor tried to sell him a variable annuity a few years ago, when he was 79. My father showed the proposal to me – the surrender period was 10 years and the fees were well over 3% per year. My father would not have been able to access this annuity without penalty until he turned 89.

What are variable annuities? Briefly, they are a mutual fund type of account overlaid with a thin layer of insurance. If you fund an annuity with after-tax money, all future gains are tax-deferred (taxed at a higher ordinary income tax rate than capital gains rates). If you fund an annuity with tax-deferred dollars, you're not doing much except adding a layer of unnecessary fees.

A recent "The Great Annuity Rip-Off" article on Forbes.com is a concise summary of the benefits (a handful) and drawbacks (many) of investing in variable annuities. Here are some key points distilled from Forbes.com and previous articles I've written about variable annuities:

1. If you truly want to convert after-tax dollars and gains to tax-deferred gains, you can pour money into a variable annuity but be aware you do NOT receive a tax deduction since annuities are not qualified retirement products.
2. It could make sense to annuitize a variable annuity (convert your lump sum to an income stream) if you end up living a substantially longer life than the statistical average.
3. Fees typically are very high – at least 2% per year, including "mortality and expenses." Some variable annuities cost 3-4% per year.
4. Investment options typically are limited and often have high underlying expense ratios.
5. The insurance component is misleading – it's not insurance in the common sense of the word. "Insurance" in variable annuities typically guarantees you'll receive at least the amount of money you initially invested into the annuity if you die (unless you have a rider that increases the coverage – but these are rare since the 2008 meltdown). If you die suddenly, you get the value of your account (if you haven't yet annuitized) – the "insurance" only has value if your investment plunged dramatically vs. your initial purchase amount.
6. Annuities are disadvantageous to inherit if they don't go to a spouse. If the money formerly was after-tax dollars, the heir receives no step-up in basis on accounts with gains. If you invest the same dollars (after tax) in a stock fund, your heirs benefit from a step-up in basis at the date of death or 9 months later. This is hard to quantify but a step-up in basis is a powerful tool to reduce capital gains taxes.
7. Disclosure to individuals – at least the clients I work with – is very poor. I typically see a lot of confusion on the part of clients who bought variable annuities. These are complex instruments with many moving parts that aren't always adequately explained (or even understand) by the seller. Folks who buy annuities don't understand the tax ins and outs and often are told variable annuities are "safe" etc.

8. Variable annuities typically lack liquidity and can tie consumer money down with prolonged surrender penalty periods.
9. Variable annuities convert lower capital gains rates on taxable income (if the annuity is purchased with after-tax dollars) into a higher tax rate levied on ordinary income. This can cost consumers significant tax dollars down the road.

Forbes cites a study by Richard Toolson (Accounting Professor at Washington State University) has looked at issue of break-even points for variable annuities vs. investing the same funds in a lower-turnover stock index mutual fund – assuming both earn the same pretax return. According to his calculations, an individual in a 36% tax bracket *will never come out ahead by investing in a variable annuity* due to the prolonged drag of fees and tax issues.

There are unusual situations when a variable annuity may make sense – e.g. doctors who are concerned about malpractice suits. Three-quarters of US states protect variable annuity assets from creditors – regular IRAs do not benefit from ERISA protection and may be more vulnerable to creditors. There are a few other instances when variable annuities may make sense – but they're few and far between. More often than not, it's clear that variable annuities always benefit the seller, and only infrequently benefit the buyer.

If a new client comes to me with variable annuities, they're immediately reviewed by an annuity expert who provides objective feedback. If the annuities are in an IRA account, it may make sense to dismantle the annuity altogether. If the annuity is funded with after-tax money (a so-called "non-qualified annuity"), it can be rolled into a less expensive annuity via a "Section 1035 Exchange." Otherwise, the annuity can't be terminated if funded with after-tax dollars.

The best policy is to steer clear of variable annuities or engage the advice of a professional who does not sell products *and isn't friends with the potential annuity seller (conflict of interest).* To quote Suze Orman: "I hate variable annuities with a passion…especially variable annuities that are used in retirement accounts…I think variable annuities were created…for one reason only…to make the financial advisor selling you those variable annuities money." Well said!