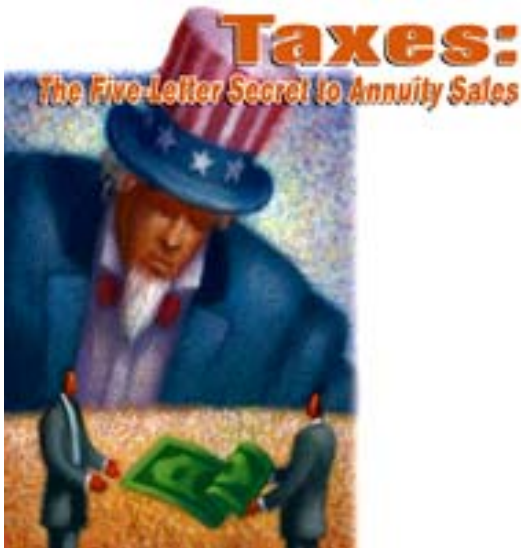


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## **Taxes: The Five-Letter Secret to Annuity Sales**

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Your prospects' tax forms may show you how they would benefit from tax-deferred annuities.

Taxes are the first word in selling tax-deferred annuities, but advisers lost that focus until recently. They chose instead to focus on rates and returns. Many successful producers are resurrecting the "T" word, however, and reaping the benefits.

When President Bush signed the latest tax law changes, it put the exclamation point on the need for tax planning as part of the producer's marketing plan for retirees. Retirees and affluent clients view tax planning as an important service they expect from their adviser.

### **Learn to Work the 1040**

The producer can get the jump on 90% of his or her competition by working Form 1040 for bigger annuity sales. Form 1040 is an excellent tool for assessing clients' ability to achieve their financial goals. The 1040 will give advisers a roadmap to their clients' assets.

Many advisers avoid discussing taxes because they don't know about all taxes. The producer doesn't have to master all the tax laws, only the ones that are most relevant to his clients. Tax issues are a major concern for clients.

This does not mean that the producer must be a tax specialist or prepare taxes. It does mean that he will review clients' tax returns to help reduce their taxes and also to see which of these new tax law provisions most will affect his clients.

### **Annuities Can Affect the 1040**

First, interest and dividends are reported to clients on 1099 forms at the beginning of each year. Whether the client spends the money or reinvests, the interest and dividends are taxable income. These are totaled on lines 8a, 8b, and 9 of page one. Schedule B is an attachment that details the sources of interest and dividends. The adage, "Pay taxes on what you spend, not what you earn," summarizes the benefits of annuities on this item.

Second, capital gains and losses are realized when an asset is sold. There are gains when the item is sold for more than its basis and losses when it is sold for less. These usually are associated with liquidating mutual funds and stocks, but also can be triggered by real estate or other asset sales.

The capital gains surprise, or realized gains from mutual funds, has become a large problem. These gains are reported on line 13 of the Form 1040 and are listed in detail on Schedule D. A tax-deferred annuity can enable the client to

avoid paying taxes on taxable gains. The producer simply can identify the kinds of assets that produce the taxable gains, then look for the equity index annuity (EIA) or total return annuity that mirrors these asset classes. These capital gains surprises from mutual funds are driving consumers to the shelter of annuities.

Third, clients pay taxes on their Social Security when their provisional income exceeds certain thresholds. These amounts are reported on lines 20a and 20b of the Form 1040. The amounts are calculated on page 27 of the tax return instructions. Provisional income includes all of the income from the "Income" boxes, including one-half of Social Security benefits plus 100% of municipal bond or "tax-free" interest. A tax-deferred annuity can reduce the amounts of taxable interest and dividends. A split annuity can control those amounts and create a tax-favored income stream that is not added back into the taxable Social Security calculation.

### **Positioning Annuities for Tax Relief**

In a tax-deferred annuity, no taxes are due on interest until the interest is withdrawn. In certificates of deposit and saving accounts, interest is taxed whether it's left to accumulate or withdrawn. The annuity's miracle of tax deferral is created through Internal Revenue Code Section 72.

Coincidentally, the benefits of IRC Section 72 can be illustrated by using the rule of 72. Basically, this shows how quickly money would double at a specified interest rate. An example of the differences based solely on tax-deferred (annuity) vs. taxable (CD) interest is shown in table 1 at left below.

Tax-deferral significantly can affect a retirement nest egg's growth potential. The tax equivalency table shown in table 2 at the bottom of the page shows the pre-tax interest rate that must be earned by a taxable account to equal the tax-deferred rate of an annuity, assuming no current distribution. For example, someone in a 31% tax bracket would have to earn 6.52% interest in a taxable account to match the annuity's tax-deferred rate of 4.5%.

Good presentation material and easy-to-understand illustrations of tax benefits are important if the producer wants to harvest the biggest benefits from this kind of planning.

### **The Capital Gains Surprise**

April 15 may be the only date when the ugly stock market loss doesn't seem like a bad thing to many mutual-fund investors.

That is because the declines in the market have generated lower fund-related taxes — or even, for some people, deductible losses — on the tax returns that investors recently wrapped up.

"It's like the consolation prize from the markets being so lousy," says a San Francisco financial adviser. Even so, U.S. mutual fund investors paid \$8.6 billion in taxes on mutual fund distributions last year.

Price Waterhouse Coopers developed a model that used historical data on the returns and expenses of mutual funds and annuity products rather than purely hypothetical assumptions. In its report released in 2002, Price Waterhouse Coopers stated that for the average annuity and mutual fund investment, its model showed that "after-tax payouts funded by annuity investments are substantially larger than mutual fund investments for holding periods as short as 10 years."

### **The Retirement Tax Trap**

What do annuities have to do with Social Security? As we discussed above, deferred annuities can lower a retiree's taxable income by reducing the amounts of taxable interest, dividends, and capital gains. Immediate annuities accomplish many of the same benefits and provide a tax-favored income.

Since 1993, retirees have been subject to income tax on up to 85% of their Social Security benefits. The greater their taxable income — including municipal bond interest and Social Security benefits — the more Social Security benefits they will be taxed. According to a report from the National Center for Policy Analysis, "Many senior citizens face a higher marginal rate than Bill Gates." Why? Because under a marginal tax rate system the last dollars earned are taxed at the highest level. In addition, when additional income also causes otherwise tax-free Social Security benefits to become taxable, it's a double whammy!

The Social Security benefits tax is imposed on up to half the benefits for single retirees with an income between \$25,000 and \$34,000 and between \$32,000 and \$44,000 for couples. This means seniors must add 50 cents in benefits to taxable income for every additional dollar they earn until half of their benefits become subject to tax.

Specialized software programs can be used to demonstrate the effects of these taxes and the benefits of annuities in addressing these tax issues.

### **The Close**

Implementing a tax plan for clients is not as complicated as the producer might think. Using some of the tools we've discussed here today, the producer can show clients that their income taxes would be reduced. The producer can use tax planning software to generate specific calculations or can keep it simpler by using federal tax tables in conjunction with the clients' tax return.

It is important for the producer to communicate two things: First, there are immediate quantifiable benefits to the clients from implementing the producer's tax plan for them. Second, unless they act, the taxes they pay will be lost. There is no way clients can use these annuity strategies to retrieve taxes they have paid in the past.

Implementing a tax plan is a process that begins when the prospects agree with the producer during the initial interview that saving on taxes is important to them. The process flows through the educational concepts. It focuses on their specific circumstances as the producer reviews and explains relevant parts of their Form 1040 tax return.

The producer can use questions to help build agreement with his tax plan. He might ask, "When do you want to stop paying taxes on your CDs and savings accounts," "Would you rather pay taxes on capital gains today, or defer those taxes until your demise," or, "How serious are you about preserving your IRA from taxation?"

### **Summary of JGTRRA**

The eight major changes of the Jobs and Growth Tax Relief Reconciliation Act for 2003 (JGTRAA) are:

1. Lower individual marginal tax rates.
2. Expansion of the lowest (10%) tax bracket.
3. Marriage penalty relief by adjusting 15% tax bracket and standard deduction for joint filers.

4. Lower taxes on capital gains and stock dividends.
5. Increase in child tax credit.
6. Limited alternative tax relief.
7. Increase in first year bonus depreciation for some fixed asset purchases.
8. Increase in small business expense (Section 179) election.

Producers who want to stay on top of the market should review significant tax planning and marketing opportunities. There are white papers and PowerPoint presentations that can be used effectively to profit from these changes.

How will the JGTRRA affect fixed annuities? The most ballyhooed change may be the lowering of taxes on dividends and capital gains to 15%. Many people may be surprised by the definition of dividends for this purpose. Eligible dividends include any dividends from domestic corporations, qualified foreign corporation or mutual funds, partnerships, real estate investment trusts, or common trust funds passing through dividends from any of those. Dividends from a money market mutual fund do not qualify, nor would most of the dividend income from a bond mutual fund because the underlying securities are paying interest.

This change in taxation sounds like it should be a big deal to our target market — retirees. But we must keep a few facts in mind. First, in 2003 the marginal tax bracket for the 15% rate caps out at taxable income of \$56,800. In other words, married taxpayers with less than \$56,800 in taxable income will pay 15% tax or less on all their income. Over two-thirds of all retirees earn less than \$50,000. That means most will not see any benefit from this change.

Second, all dividends and capital gains still are included for purposes of computing the amount of taxable Social Security. This tax law change offers no relief to that situation.

Finally, it might be extremely difficult to convince retirees who were pummeled in the market for the past three years to get back into the market. The benefit here is to annuities because the clients can receive tax-favored income from immediate annuities or systematic withdrawals from equity index annuities and protect their principal against losses.

The producer should review his seminar and other marketing material. Retirees have not fully digested these tax law changes, and that means producers have the opportunity to educate. Education can be an important bridge in building a trusted adviser relationship and growing a practice.

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