TAXES DRAGGING DOWN CLIENTS' PORTFOLIOS?

A tax-deferred investment vehicle may help clients build more wealth—faster.

Would clients value having 100% of every invested dollar—and any gains—work for them until needed? Even if the answer is maybe, it may be important to consider the after-tax returns of both nonqualified and qualified investment vehicles. Each vehicle can have different tax characteristics, and those differences often impact each client differently.

First, let's consider what tax drag is and why it can matter. Then, we'll review some factors to consider.

What Is Tax Drag?

Tax drag occurs when taxes on current investment income reduce the dollars available for reinvestment. This can affect the pace at which money grows. High-income clients may have federal taxes on unearned income as well as the potential for additional taxes, such as the net investment income tax (NIIT) and the alternative minimum tax (AMT). Add state taxes, and effective tax rates of 30% or more can be a reality. Good tax management can have a positive effect on overall returns. Tax drag can cause money to grow less efficiently.

What Is Tax Control?

Tax control is the ability for a client to decide when to recognize gains and pay taxes on income through the timing of withdrawals. For some clients with large nonqualified investment accounts, a tax-deferred fixed or variable annuity may offer additional tax control as these accounts do not have a requirement for distribution until the age of contract maturity, typically age 100.

Factors to Consider When Evaluating the Value of Tax Deferral

Traditional defined contribution accounts as well as traditional IRAs offer tax deferral but their ability to offer tax control is more limited. Unlike a nonqualified fixed or variable annuity, once the client reaches their required beginning date (RBD), distributions (and payment of the associated taxes) must begin. Some factors to consider when analyzing a client's portfolio are listed below.

- **Effective tax rate.** Knowing a client's effective tax rate (that is, taxes paid divided by income) is critical to good tax management. Clients often focus on marginal rates when what matters is the actual percentage of income paid in taxes. In retirement, most clients will have only unearned income, so FICA does not apply. Some may have the NIIT. That said, federal, state, and/or local taxes can push the effective rate up, especially in high-tax states.

- **Accumulation versus retirement income.** During accumulation years, tax deferral allows 100% of the net-of-fee dollars to go to work. This can mean more dollars later or a shorter time frame to reach a goal. In retirement, tax control may better help manage income because a client can choose when to take withdrawals and pay the associated taxes. It is important to evaluate each based on the specific purpose.

- **Comparable portfolios.** A common issue when evaluating after-tax and tax-deferred accounts is failure to compare similar portfolios. As an example, long-term capital gains (LTCGs) may be very beneficial in an after-tax portfolio. In a tax-deferred portfolio, distributions are considered ordinary income, regardless of the tax characteristics of the underlying investments. Unless the two portfolios are similar, results may skew in one direction or the other based on the tax characteristics of the investments.

Asset location can improve overall portfolio performance by taking advantage of the different tax characteristics of investments. Investments that favor the lower tax rates, such as LTCG investments and qualifying dividends, are well suited to an after-tax account. As most deferred accounts produce ordinary income, placing investments that tend to produce ordinary income in those accounts can make sense. A good software program for tax analysis will help determine options.

Next Steps

Tax deferral in strategies that allow clients to time and control the recognition of gains can help reduce or smooth out tax costs. Regular evaluation of a client's effective tax rate and sources of income can mean more assets stay invested. After tax season is a great time to reach out to clients to determine if a strategy that provides tax deferral and tax control might benefit them.

This material is educational and intended for an audience with financial services knowledge.

Additional Resources and Links

The Power of Tax Deferral Calculator

The Power of Tax Deferral

New IRS Mortality Table Means and "RMD Checkup" is Due in 2022

For more information about retirement planning, please contact our Retirement Strategies Group at RSG@PacificLife.com or (800) 722-2333, ext. 3939.
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Annuity withdrawals and other distributions of taxable amounts, including death benefit payouts, will be subject to ordinary income tax. For nonqualified contracts, an additional 3.8% federal tax may apply on net investment income. If withdrawals and other distributions are taken prior to age 59½, an additional 10% federal tax may apply. A withdrawal charge also may apply. Withdrawals will reduce the contract value and the value of the death benefit, and also may reduce the value of any optional benefits.

Under current law, a nonqualified annuity that is owned by an individual is generally entitled to tax deferral. IRAs and qualified plans—such as 401(k)s and 403(b)s—are already tax-deferred. Therefore, a deferred annuity should be used only to fund an IRA or qualified plan to benefit from the annuity's features other than tax deferral. These features include lifetime income, death benefit options, and the ability to transfer among investment options without sales or withdrawal charges.

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VLC2657-1122W

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