

PRINT FORMAT SPONSORED BY  
 **COMMONWEALTH**  
*financial network*  
Helping independent financial advisors  
pursue their vision for success

# InvestmentNews

The Leading News Source for Financial Advisers

## Advisers create exit plans for underwater VAs

But strategy to bail can backfire unless every detail is analyzed

By **Darla Mercado**  
April 26, 2009

The term "bailout" has taken on new meaning for financial advisers as they devise ways to free clients from underperforming variable annuities, but the path to freedom is paved with possible tax complications and worries about account churning.

Advisers cite a range of reasons behind exiting variable annuities. Signs that it is time to bail include a series of deep losses, the desire to take advantage of a large death benefit and the realization that a VA investment that made sense years ago may now be inappropriate for the client, advisers say.

But getting out of variable annuities requires advisers to seek out minute details within the annuity contract to keep the strategy from backfiring.

"Part of the problem I see with some recommendations that are given is that you have to look at what happens with the annuity's death benefit and living benefit and the way they relate to each other," said Jim Hyre, managing principal of Hyre & Associates in Columbus, Ohio, which manages \$75 million in assets. "In many cases, it can make sense for the client to do nothing."

Mr. Hyre counts annuity "stripping" and VA annuitization via guaranteed minimum income benefits among his bailout strategies.

In one example, he freed a 62-year-old client from a variable annuity that had fallen to \$350,000, from \$500,000. The product, which was out of its surrender period, was less than stellar as an investment, but a \$780,000 death benefit presented an opportunity, especially because the client was uninsurable.

### InvestmentNews Reprints



This copy is for your personal, non-commercial use only. To order presentation-ready copies for distribution to your colleagues, clients or customers, use the Reprints tool or the Reprints link at the top or bottom of any article, respectively.

- [View reprint options](#)
- [Order a reprint article now](#)

In order to allow the investor to use his account dollars for a more worthwhile purpose while maintaining the rich death benefits, Mr. Hyre "stripped" the annuity, withdrawing all but \$1,000 from the contract.

This kept the contract in force and maintained most of the death benefit. Also, because the death benefit was dollar-for-dollar, the withdrawal from the account balance reduced the death benefit by an equal amount, as opposed to pro rata, which would have reduced the death benefit by even more.

The withdrawn funds were subsequently used to buy another annuity with a death benefit that had a 6% annual increase until the client reached age 85.

"Life insurance wasn't an option, and [the client's] goal was to maximize what would be left for the kids," Mr. Hyre said. But he added that this strategy works best when qualified accounts are involved to allow trustee-to-trustee transfers and when the client is over 59½ to avoid early withdrawal penalties.

A variable annuity inside a qualified account, such as an individual retirement account, could ease the transfer from one IRA to another, avoiding a tax bite.

However, clients can't recognize the investment loss when transferring qualified annuity assets this way, said Lisa Kirchenbauer, president of Omega Wealth Management LLC in Arlington, Va. Her firm manages about \$45 million.

In a 73-year-old client's case, a steep loss in a variable annuity that was inside a qualified account allowed that investor to reap tax benefits — albeit in a different way. In this case, a \$33,500 variable annuity that was purchased in 1999 fell as low as \$19,500 as of December.

The money was a tiny portion of the client's portfolio, but Ms. Kirchenbauer thought that it was unlikely that the variable annuity, which was invested wholly in the stock market, would recover soon.

The client withdrew the money and donated it to charity, getting a tax write-off for doing so.

Industry observers pointed out that, at least anecdotally, more advisers appear to be crafting exit strategies from underwater variable annuities. But they note the importance of exiting legitimately, as opposed to "churning" the annuity, particularly in newer products with skimpy benefits and high surrender fees.

"If they don't touch the assets, at some point the market will pick up and the assets will begin to grow again," said Garth Bernard, president and chief executive of Sharper Financial Group, a Boston retirement-product consulting firm. "If the primary purchase was to ensure a lifetime income, then that's what the client got, so trying to restructure the situation in general is changing the original intent of the purchase."

A decision to flee a variable annuity should be based on more than just the client's nervousness about heavy paper losses.

## 'LOCKING THE LOSS'

 Enlarge This Photo

"It's no fun getting out of a [variable annuity] that's been recently sold, because of surrender charges and low values, and by moving you're locking the loss," said Elvin D. Turner, managing director of Turner Consulting LLC in Bloomfield, Conn.

But what is on experts' minds is the idea of advisers using VA living benefits to bail out clients, as Mr. Hyre and Eric Brotman, president of Brotman Financial Group Inc., have done. The Timonium, Md. firm manages \$50 million in assets.

In Mr. Brotman's case, a 60-year-old client held an equity-heavy annuity in an IRA that had fallen in value. The client didn't need to take withdrawals from the IRA and was still working.

Mr. Brotman thought that the account value would never recover fully, so he decided to use the variable annuity's guaranteed lifetime withdrawal benefit to invest elsewhere.

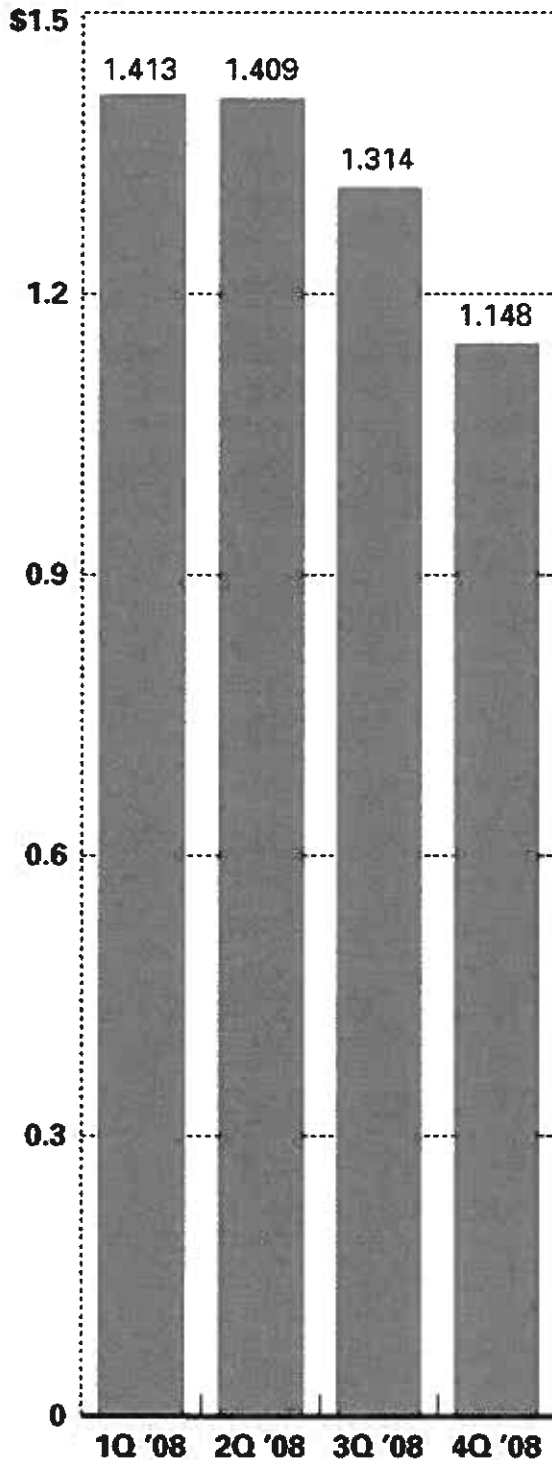
Distributions from the rider were based on the original benefit base, and they went into a second IRA that invested in exchange traded funds, using a 50/50 mix of equities and fixed income.

Mr. Brotman warned that the strategy must have a guaranteed lifetime withdrawal benefit with no automatic step-up and that the client must be at least 60 to avoid withdrawal penalties. Further, the adviser needs to figure out whether there is indeed a likelihood that the account will grow if the client waited 20 years to use the rider.

"This is a strategic opportunity to build another nest egg with proceeds from the first that will never grow," Mr. Brotman said. "You have accepted an income stream in lieu of principal, and its value is more than the contract will ever be worth."

## VA-moose

Variable annuity assets at quarter end, \$ in trillions



Source: LIMRA International Inc.

Mr. Brotman said that some contracts allow quick implementation of the riders, but clients must not take more than the designated distribution, or else the strategy will unravel.

In one client's situation, Mr. Hyre used a VA guaranteed minimum income benefit to fund a universal life insurance policy inside an irrevocable life insurance trust. Experts say that this particular strategy works against carriers, which may not have expected increased rider use, and they recommend that advisers closely read their contracts first.

"It definitely flexes against the insurance companies, but the contracts can have different and narrow provisions," Mr. Turner said. "And just because the guy at the next desk can do it doesn't mean that you can."

E-mail Darla Mercado at [dmercado@investmentnews.com](mailto:dmercado@investmentnews.com).

Reproductions and distribution of the above news story are strictly prohibited. To order reprints and/or request permission to use the article in full or partial format please contact our Reprint Sales Manager at (732) 723-0569.