

1997--Summer Quarter

Items of Interest to WESCAP Clients and Other Interested Readers

Mutual Funds versus Annuities

The recent proposal to cut capital gains taxes from a maximum of 28% to 20% (or lower) reduces the appeal of tax-deferred annuities and non-deductible IRAs. It has been announced that should the capital gains tax cut be passed, it would be effective as of May 7, 1997.

Most variable annuities are purchased for their long-term tax deferral. Nothing is taxed until withdrawals are made. Under the proposed tax rules, these annuities become less attractive. To understand why, we can review the following example:

	<u>Before Fees</u>
Investment Average Appreciation	9.5%
Investment Dividend Rate	<u>2.5%</u>
Total Assumed Rate of Return	12.0%
Mutual fund Annual Fees	0.8%
Variable Annuity Fees	1.3%
Ordinary Tax Rate--Federal	31.0%
Ordinary Tax--State	9.3%
Capital Gains Tax Rate	20.0%
Combined Tax Rate on Annuity	37.4%
Combined Tax Rate on Mutual Fund	27.4%

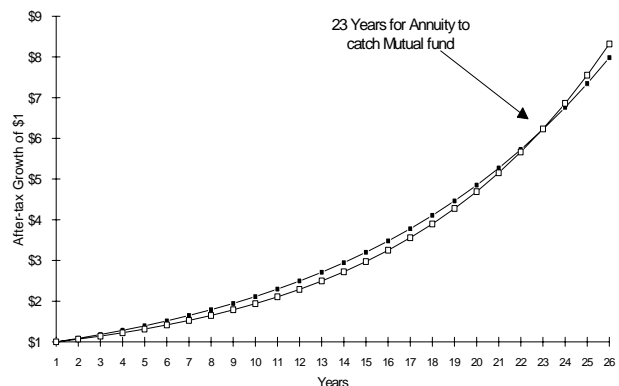
Return After Fees on Investment in a:

	<u>Mutual Fund</u>	<u>Variable Annuity</u>
Gain	9.5%	9.5%
Dividends (net of fees)	<u>1.7%</u>	<u>1.2%</u>
Total return	11.2%	10.7%

We assume you pay capital gain and ordinary income taxes on the mutual fund every year. In reality most mutual funds can defer a part of their gain for a few years. Thus this puts our example mutual fund at a disadvantage to most "real life" mutual funds. This makes the following conclusions even more telling. In our example, the annuity is not taxed until at the end when all

assets are withdrawn at once. The returns shown are what one might expect from a more aggressive stock fund over a long period of time.

The variable annuity has a lower return due to higher annual expenses (most annuities have fees even greater than in our example). Also, what would have been mostly capital gain is instead converted to ordinary income upon withdrawal. Thus the annuity also has a tax *rate* disadvantage. With the proposed **lower 20%** capital gains tax, it is expected to take **23 years** for the annuity to catch-up and surpass the mutual fund, after taxes and after expenses.



Using the current capital gain tax rate of **28%**, it takes *only 18 years* for a tax deferred annuity to surpass the mutual fund. In either case, this is a long time. Unless you have a very long time horizon (and some of you should), tax deferred annuities need to be viewed with some skepticism.

A lower total rate of investment return makes the comparison even worse for the annuity. If we lower the capital appreciation rate by 3% per year from the first example, it increases the required break-even time to **31 years**. If you are going to use a variable annuity, it generally should

be used for your most aggressive investments. If, for strategic reasons you need to own fixed income investments, then you can make a case for using deferred annuities as long as you don't need the income (paradoxically) for at least **8 to 10 years**.

Non-deductible IRAs are also less attractive for the same tax reasons. However, unlike the annuity, they are not more expensive. With rates of return and a capital gain tax rate the same as the first example, the

breakeven time for the IRA investment to equal or exceed the mutual fund is **16 years**. Under the current 28% capital gain tax rate, the time period is shorter at **8 years**. Only at the higher 28% capital gain tax rate does the non-deductible IRA have substantial investment appeal.

You should also consider insurance features, pre-age 59-1/2 penalties, changing tax and estate codes and tax bracket changes before investing in a tax deferred variable annuity.

If you have questions about the above, please contact Mark Gleason, Rick Weinlein or Joel Edstrom at (818) 552-2130 or fax to (818) 552-2133. WESCAP Management Group has obtained information from sources believed to be reliable, but no guarantee can be made as to its accuracy. WESCAP Management Group provides high quality, personalized, objective financial and investment advice to individuals.

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