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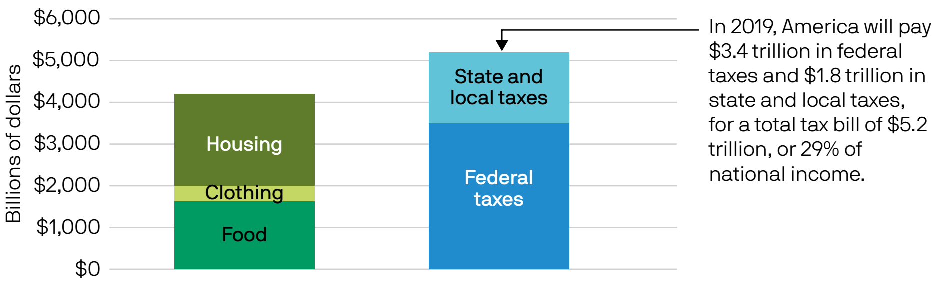
Capitalizing on the tax-deferral advantage of a variable annuity

J.P. Morgan Asset Management

Consider proactive tax-management strategies

Most investors understand the value of asset allocation and investment selection in the wealth-building process. However, maximizing after-tax wealth remains an important priority, especially for high-income earners. In 2019, Americans collectively were expected to spend more on taxes than on food, clothing and housing combined.[1] Without the proper planning, investment earnings can make your tax burden even heavier.

Americans will spend more on taxes in 2019 than on food, clothing and housing combined



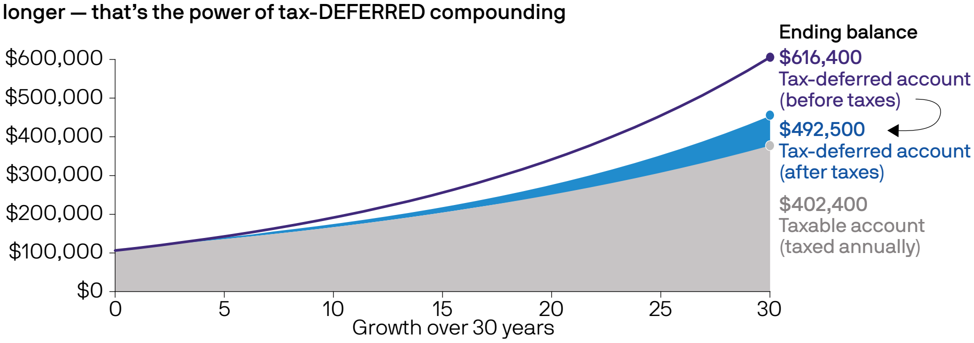
Source: Bureau of Economic Analysis: Tax Foundation calculation.

[1] Tax Foundation, 2019.

Tax-deferred annuities likely to remain attractive

While recent tax laws lowered the top marginal tax rate and expanded some income tax brackets, tax-deferred investing continues to be a valuable retirement saving strategy. The longer money is invested, the greater the benefit from tax deferral and compounding. Investors may consider using tax-efficient investing vehicles, such as variable annuities, whose assets generate ordinary income and short-term capital gains. Variable annuities defer the recognition of earnings and gains for income tax purposes, providing significantly more tax-deferred growth over time, after the extra costs of these vehicles are taken into account. For investors with a higher tax liability and higher investment returns, the benefits of a variable annuity could be even greater.

The gap between a taxable vs. tax-deferred account grows larger as the time frame becomes longer — that's the power of tax-DEFERRED compounding



Taxes can wait

Sheltering investment growth in tax-deferred accounts over the long term may result in more wealth for retirement. The value of tax deferral in this example is equivalent to a 0.7% higher annual return over the time period.

Hypothetical assumptions

1. $100,000 initial investment
2. 24% tax rate
3. 6.25% compounded annual rate of return

Source: J.P. Morgan Asset Management. Chart assumes an initial after-tax account value of $100,000 for each account type. Assumes a 6.25% annual return for both accounts. Investment returns in taxable account are taxed annually at 24% (capital gains and qualified dividends are not considered in this analysis). Tax-deferred account balance is taken as a lump sum after year 30 and investment returns (account balance net of initial investment) are taxed at 24% federal tax rate. If tax-deferred account is taken as lump sum at other tax rates, the after-tax balance would be $554,400 (12%), $502,800 (22%), $451,200 (32%), $435,700 (35%) and $425,300 (37%). This hypothetical illustration is not indicative of any specific investment and does not reflect the impact of fees or expenses. This chart is for illustrative purposes only. Past performance is no guarantee of future results.

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Keeping more of what you earn

All investors must pay their fair share of taxes. Our complicated U.S. tax code recognizes different sources of investment gains and taxes them at different rates. In some instances, the taxation of these gains may occur at a later time ("tax deferral"), which allows for compounded growth as well as the deferral of ordinary income taxation.

Some asset classes are more tax efficient than others

Many asset classes held in taxable accounts — including fixed income, hedge funds, REITs and some equities — are tax inefficient. In other words, the gains on these investments may be taxed either at the individual's highest tax rate or on an annual basis, or both.

Assets at the individual's highest income tax rate that produce less tax-efficient returns, and that have longer holding periods, can underscore the value to investors of holding these assets in a tax-deferred vehicle. J.P. Morgan estimates that a variable annuity has potential to provide an investment benefit that could possibly exceed 100 basis points per year.

Over the last 15 years, some of the best-performing asset classes were also some of the most tax inefficient

Asset class returns

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2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	YTD	2007 - 2021 Ann.	2007 - 2021 Vol.
EM Equity 39.8%	Fixed Income 5.2%	EM Equity 79.0%	REITs 27.9%	REITs 8.3%	REITs 19.7%	Small Cap 38.8%	REITs 28.0%	REITs 2.8%	Small Cap 21.3%	EM Equity 37.8%	Cash 1.8%	Large Cap 31.5%	Small Cap 20.0%	REITs 41.3%	Comdty. 25.5%	Large Cap 10.6%	REITs 23.2%
Comdty. 16.2%	Cash 1.8%	High Yield 59.4%	Small Cap 26.9%	Fixed Income 7.8%	High Yield 19.6%	Large Cap 32.4%	Large Cap 13.7%	Large Cap 1.4%	High Yield 14.3%	DM Equity 25.6%	Fixed Income 0.0%	REITs 28.7%	EM Equity 18.7%	Large Cap 28.7%	Cash 0.0%	Small Cap 8.7%	EM Equity 22.9%
DM Equity 11.6%	Asset Alloc. -25.4%	DM Equity 32.5%	EM Equity 19.2%	High Yield 3.1%	EM Equity 18.6%	DM Equity 23.3%	Fixed Income 6.0%	Fixed Income 0.5%	Large Cap 12.0%	Large Cap 21.8%	REITs -4.0%	Small Cap 25.5%	Large Cap 18.4%	Comdty. 27.1%	Asset Alloc. -3.9%	REITs 7.5%	Small Cap 22.5%
Asset Alloc. 7.1%	High Yield -26.9%	REITs 28.0%	Comdty. 16.8%	Large Cap 2.1%	DM Equity 17.9%	Asset Alloc. 14.9%	Asset Alloc. 5.2%	Cash 0.0%	Comdty. 11.8%	Small Cap 14.6%	High Yield -4.1%	DM Equity 22.7%	Asset Alloc. 10.6%	Small Cap 14.8%	Large Cap -4.6%	High Yield 6.6%	Comdty. 19.1%
Fixed Income 7.0%	Small Cap -33.8%	Small Cap 27.2%	Large Cap 15.1%	Cash 0.1%	Small Cap 16.3%	High Yield 7.3%	Small Cap 4.9%	DM Equity -0.4%	EM Equity 11.6%	Asset Alloc. 14.6%	Large Cap -4.4%	Asset Alloc. 19.5%	DM Equity 8.3%	Asset Alloc. 13.5%	REITs -5.3%	Asset Alloc. 5.7%	DM Equity 18.9%
Large Cap 5.5%	Comdty. -35.6%	Large Cap 26.5%	High Yield 14.8%	Asset Alloc. -0.7%	Large Cap 16.0%	REITs 2.9%	Cash 0.0%	Asset Alloc. -2.0%	REITs 8.6%	High Yield 10.4%	Asset Alloc. -5.8%	EM Equity 18.9%	Fixed Income 7.5%	DM Equity 11.8%	High Yield -5.7%	EM Equity 4.8%	Large Cap 16.9%
Cash 4.8%	Large Cap -37.0%	Asset Alloc. 25.0%	Asset Alloc. 13.3%	Small Cap -4.2%	Asset Alloc. 12.2%	Cash 0.0%	High Yield 0.0%	High Yield -2.7%	Asset Alloc. 8.3%	REITs 8.7%	Small Cap -11.0%	High Yield 12.6%	High Yield 7.0%	High Yield 1.0%	DM Equity -5.8%	DM Equity 4.1%	High Yield 12.2%
High Yield 3.2%	REITs -37.7%	Comdty. 18.9%	DM Equity 8.2%	DM Equity -11.7%	Fixed Income 4.2%	Fixed Income -2.0%	EM Equity -1.8%	Small Cap -4.4%	Fixed Income 2.6%	Fixed Income 3.5%	Comdty. -11.2%	Fixed Income 8.7%	Cash 0.5%	Cash 0.0%	Fixed Income -5.9%	Fixed Income 4.1%	Asset Alloc. 11.7%
Small Cap -1.6%	DM Equity -43.1%	Fixed Income 5.9%	Fixed Income 6.5%	Comdty. -13.3%	Cash 0.1%	EM Equity -2.3%	DM Equity -4.5%	EM Equity -14.6%	DM Equity 1.5%	Comdty. 1.7%	DM Equity -13.4%	Comdty. 7.7%	Comdty. -3.1%	Fixed Income -1.5%	EM Equity -6.9%	Cash 0.8%	Fixed Income 3.3%
REITs -15.7%	EM Equity -53.2%	Cash 0.1%	Cash 0.1%	EM Equity -18.2%	Comdty. -1.1%	Comdty. -9.5%	Comdty. -17.0%	Comdty. -24.7%	Cash 0.3%	Cash 0.8%	EM Equity -14.2%	Cash 2.2%	REITs -5.1%	EM Equity -2.2%	Small Cap -7.5%	Comdty. -2.6%	Cash 0.7%

Source: Bloomberg, FactSet, MSCI, NAREIT, Russell, Standard & Poor's, J.P. Morgan Asset Management.
Large cap: S&P 500, Small cap: Russell 2000, EM Equity: MSCI EME, DM Equity: MSCI EAFE, Comdty: Bloomberg Commodity Index, High Yield: Bloomberg Global HY Index, Fixed Income: Bloomberg US Aggregate, REITs: NAREIT Equity REIT Index, Cash: Bloomberg 1-3m Treasury. The "Asset Allocation" portfolio assumes the following weights: 25% in the S&P 500, 10% in the Russell 2000, 15% in the MSCI EAFE, 5% in the MSCI EME, 25% in the Bloomberg US Aggregate, 5% in the Bloomberg 1-3m Treasury, 5% in the Bloomberg Global High Yield Index, 5% in the Bloomberg Commodity Index and 5% in the NAREIT Equity REIT Index. Balanced portfolio assumes annual rebalancing. Annualized (Ann.) return and volatility (Vol.) represents period from 12/31/2006 to 12/31/2021. Please see disclosure page at end for index definitions. All data represents total return for stated period. The "Asset Allocation" portfolio is for illustrative purposes only. Past performance is not indicative of future returns.
Guide to the Markets – U.S. Data are as of March 31, 2022.

Investing Principles

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This chart is hypothetical and for illustrative purposes only. Past performance is no guarantee of comparable future results.

What's the difference between tax-efficient and tax-inefficient investments?

An investment's tax efficiency is determined by both its expected return and the tax rate on such return.

- As a general rule, bonds or bond funds may be more tax inefficient because almost all of the return comes from the dividend yield, which is fully taxed as ordinary income.
- In contrast, stocks get most of their return from price appreciation. You're not taxed until the stocks are sold and the gains are taxed at the capital-gains tax rate. Shares held for longer than one year are subject to long-term tax rates.
- Stock funds can be tax inefficient if they generate a lot of short-term gains; they are also less efficient if they pay high ordinary dividends. Under current law, qualified dividends are taxed at lower rates.

Why does it matter?

Taxes can have a big impact on long-term investment returns — making the benefit of a tax-deferred variable annuity especially attractive for high net worth and affluent investors focused on retirement.

While taxes should not be the sole driver of investment decisions, investors should be tax aware

Type of return taxed	Description
Interest income	Interest payments from bond or money market fund holdings
Stock dividends	Paid by companies that share profits with stockholders
Short-term capital gains	Profits on the sale of investments held for one year or less
Long-term capital gains	Profits on the sale of investments held longer than one year

When do you have to pay federal taxes on investment earnings?

It depends on what type of account you own. Here are some guidelines:

- Taxable account: Taxes are payable in the year in which returns are earned.
- Tax-deferred accounts: Investment earnings in traditional IRAs, 401(k)s and annuities aren't taxed until withdrawn. Early withdrawals before age 59½ usually incur an additional 10% federal penalty tax. Distributions from qualified accounts must begin by or before age 72 (70½ if you reach 70½ before January 1, 2020).

Who might benefit most from a tax-deferred variable annuity ?

- Individuals with high marginal income tax rates: As a general rule, the higher an investor's marginal income tax rates, the greater the advantages of tax deferral.
- Those who expect lower marginal taxes at retirement — when withdrawals will be taxed at a then-lower rate.
- Investors with 10 or more years to retirement: Time is a significant factor, as the compounded advantages of tax-deferred earnings help build account values effectively. The advantage of tax deferral is proportional to the amount of time available before assets are withdrawn from the deferred account.
- Investors who hold a significant share of assets in taxable accounts: Variable annuities may be an attractive option for investors who have maxed out their employer plans and IRAs.

Top tax rates for ordinary income, capital gains and dividend income

Type of return	Maximum rate
Ordinary income & non-qualified dividends	37%/40.8%*
Short-term capital gains (assets held 12 months or less)	37%/40.8%*
Long-term capital gains (assets held more than 12 months) & qualified dividends	20%/23.8%*

Alternative minimum tax (AMT) exemption**

Filing status	Exemption	Exemption phase-out range
Single/Head of Household	$75,900	$539,900–$843,500
Married filing jointly	$118,100	$1,079,800–1,552,200

Source: J.P. Morgan Asset Management 2022 Guide to Retirement, page 51.

*Includes top tax rate plus 3.8% Medicare tax on the lessor of net investment income or excess of MAGI over threshold (single threshold $200,000; married filing jointly $250,000).

**The exemption amount is reduced .25 for every $1 of AMTI (income) above the threshold amount for the taxpayer's filing status. For AMTI above the top range, the exemption will be $0.

Consult a professional

A financial professional or tax advisor can explain if these or other strategies meet your individual needs.

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Variable annuity guarantees are only as good as the insurance company that gives them. While it is an uncommon occurrence that the insurance companies that back these guarantees are unable to meet their obligations, it may happen. Annuity withdrawals prior to 59½ may be subject to tax penalties, are subject to market risk and may lose value. Riders have additional fees and costs associated with them, and are subject to additional conditions, restrictions and limitations.

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