Demming Financial Services Corp.

Annuities

Although not unilaterally opposed to annuities, Demming Financial Services Corp. (DFSC) generally discourages their purchase. We never recommend pretax (qualified) annuities and rarely use after-tax (non-qualified) ones, and when we do, they are mostly due to 1035 exchanges. They are called this because 1035 refers to the specific provision in the tax code that allows for the direct transfer of one annuity to another, without creating a taxable event. These exchanges allow clients to consider replacing underperforming or high-cost annuities with lower cost alternatives, while preserving the tax-deferred status of qualified annuities already owned by clients.

We are not proponents of annuities because . . . .

1) **High Cost:** Costs are generally 2-4 times higher per year than other comparable investments. The average annuity has mortality expenses, in addition to normal management fees; mutual funds have only management fees.

2) **Lack of Liquidity:** Most clients need liquidity. Because of their surrender fees and 10% early withdrawal penalties prior to age 59½, annuities sacrifice that precious commodity called flexibility.

3) **Loss of Tax Advantages:** Although annuities are generally marketed on their tax benefits, just the opposite is the case. Annuities sacrifice the utilization of favorable long-term capital gains treatment and convert long-term gains to ordinary income at distribution. In addition, upon the owner's death, an annuity condemns either the deceased or the beneficiaries to paying taxes on the accumulated cash build-up – the tragedy being that the beneficiaries sacrifice a 'step-up in cost basis,' thus exposing themselves to unnecessary taxes.

4) **Misinterpreted Guarantee:** Many times annuities are marketed as 'risk-free' investments that somehow absolve the personal responsibility of the individual. The investor is committing to a long-term investment horizon in order for that 'guarantee' to be fulfilled. The 'cost' for these assurances is prohibitive when overlaid against investment benchmarks over similar time horizons.

In summary, annuities are high-cost, illiquid investments that offer poor tax benefits at distribution. As long as capital gains rates are 5-15%, with the possibility of a step-up in cost basis at death being zero tax, annuities are not an attractive investment.