Adviser compensation is the challenge with fee-based annuities

Advisers who pull their fee from nonqualified annuities could cause a taxable event for their clients

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By **Greg Iacurci**

Fee-based annuities are becoming more popular, but there's a thorny issue that could limit their uptake and negatively affect clients: the question of how an adviser is paid to help manage the annuity.

Fee-based annuities are products meant for registered investment advisers, who are paid a flat, annual advisory fee, often based on assets under management, rather than a commission for each product sale. These annuities don't come with a sales load to compensate the adviser.

This feature may create a conundrum for RIAs. Pulling the advisory fee from some annuity products — specifically, nonqualified annuities — is a taxable event for the client, essentially making the financial advice more expensive.

"The compensation issue is kind of the big [challenge]," David Lau, founder and CEO of DPL Financial Partners, which distributes annuity products for RIAs, said of fee-based annuities.

Pulling an adviser's fee from a nonqualified annuity policy that's sold outside a retirement account, such as an IRA, counts as a taxable distribution at ordinary income rates, reflected on a 1099 tax form.

That's not the case with qualified products. The Internal Revenue Service considers withdrawals for adviser fees to be nontaxable to the client, because it regards these fees as an expense related to the taxpayer's financial plan, said Craig Hawley, head of Nationwide Advisory Solutions.

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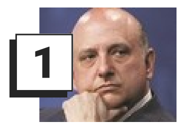

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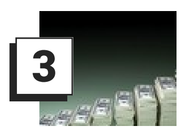

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portfolio. This is likely the case since gains, not principal, are distributed first from an annuity.

For example, let's say a client invested $100,000 in a nonqualified variable annuity that is now worth $150,000. A $100,000 distribution would yield tax on only the $50,000 of gain.

Insurers sold $3.2 billion of fee-based variable annuities in 2018, up 42% from the year before, according to the Limra Secure Retirement Institute. They now represent around 3% of overall VA market share, double their share in 2016.

Insurers launched a slew of products in 2016 and 2017, around the time the Department of Labor fiduciary rule, now defunct, looked as if it would **push more clients into fee-based arrangements.** Insurers such as Jackson National Life Insurance Co. have **recently made efforts** to boost distribution of fee-only products.

Given the increasing sales of no-load annuities and advisers' continued shift to fee-based business, it isn't fair to assess a tax penalty on advisory fee distributions, Mr. Lau said.

Pulling an advisory fee from the annuity could have other adverse effects — if the product has a living-benefit rider of some kind, pulling out too much money from the annuity could dilute or nullify those benefits.

"You could be in situation where the way the adviser is getting paid could decrease the benefit the customer is getting," Mr. Hawley said.

However, there are workarounds to the problem. Many advisers pull their fee from a centralized client account rather than from the annuity, typically taking from liquid assets large enough to cover the periodic adviser fee.

This is the approach Michael Ross, president of Financial Connection Inc., uses. "Clients usually have cash somewhere, so there's usually a place to do it," he said.

Insurers also appear to be addressing the problem by **building out technology** that better facilitates this centralized billing for advisers.

accounted for in portfolio management software, Mr. Lau said.

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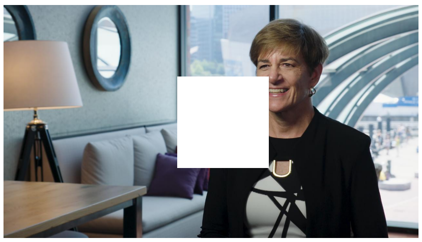

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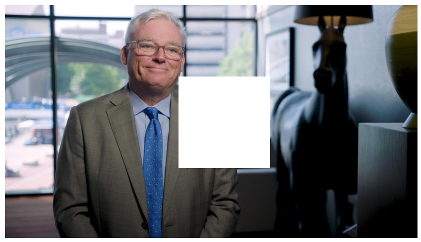

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