Advanced annuity marketing concepts

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Breaking down and simplifying advanced annuity and IRA planning techniques

When your clients have complex annuity and IRA planning needs, you can count on Nationwide's **Advanced Consulting Group** to help you simplify these topics.

What's inside?

This brochure was designed to provide a brief overview of some of the most commonly used annuity and IRA planning strategies — including the benefits, tax considerations and steps necessary to put each plan in place.

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Legacy planning with an IRA deferred annuity

Concept

Create multiple IRAs to attempt to make legacy planning of IRA money as effective as possible.

Benefits

Have one IRA for required minimum distributions (RMDs) and another IRA annuity for death benefit protection. The first IRA will be funded with enough IRA assets to cover RMDs for all IRAs. The second IRA annuity will remain untouched for as long as possible to allow the guaranteed death benefit amount to grow without being reduced by distributions.

Our spousal protection death benefit options can provide additional death benefit protection by covering both the IRA owner and the owner's spouse. The contract value is increased to the death benefit value on the death of the IRA owner and/or the owner's spouse, depending on the product. The surviving spouse also gains liquidity because any remaining surrender charges are waived after processing the death benefit.

For this concept, both spouses must be co-annuitants and primary beneficiaries. Owner-driven annuity products may offer similar spousal protection features on nonqualified deferred annuities by naming both spouses as joint owners. However, with IRA annuities, joint ownership is not permitted, so only an annuitant-driven contract, such as many of Nationwide's annuity contracts, can offer death benefit protection for both spouses because payment of a death benefit is triggered upon the death of the spouses as co-annuitants.

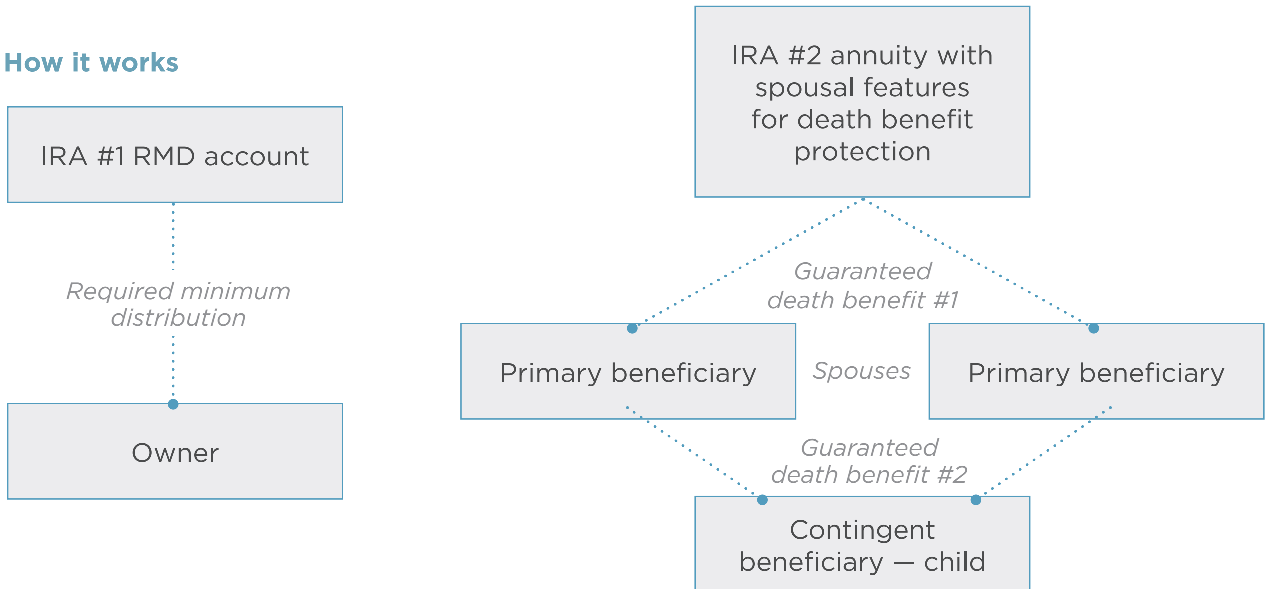
Tax considerations

- Required minimum distributions (RMDs) must be taken by April 1 of the year after the IRA owner turns 72 and must continue to be taken every year thereafter
- Cumulative RMD amounts calculated from all nonannuitized IRA funds may be taken from any one IRA or a combination of IRAs
- Clients can use a trustee-to-trustee transfer or rollover to separate IRA funds into more than one account
- A direct trustee-to-trustee transfer should be used whenever possible
- Any RMD not taken in a timely manner is subject to a 50% tax penalty

Steps

- The client will utilize two nonannuitized IRAs, one for RMDs and one for an IRA annuity with death benefit features
- The client will take the RMD amount for all their IRAs from the IRA specifically set up for RMD withdrawals (IRA #1 RMD account)
- RMD amounts will be taken from the IRA RMD account for as long as possible
- As the guaranteed death benefit grows in the IRA annuity, this amount is locked in within the contract not being used for distributions
- See Page 20 for an answer to what nonspouse beneficiaries can do with the IRA money they inherit from the IRA at the death of the second spouse

How it works



Target audience: *married clients who want to leave some of their IRA assets behind to their spouse and child(ren)*

Income planning in an IRA deferred annuity

Concept

Purchase a deferred annuity with a living benefit in an IRA to create guaranteed lifetime income with growth potential.

Benefits

This can help facilitate the transition of accumulation products into retirement income products. Consider an IRA annuity with a living benefit as a possible bond/fixed income replacement within the client's investment portfolio, especially in low interest rate environments.

Tax considerations

- Unless there are nondeductible contributions to the IRA, all distributions received from an IRA will be taxed as ordinary income in the year received, and the remaining balance will receive tax deferral
- If the IRA annuity with a living benefit is the only IRA account, then distributions may be delayed only until RMDs are required at age 72
- If the IRA owner has multiple IRAs, then distributions from the IRA annuity with a living benefit can be avoided if the full RMD amounts for all the client's IRAs are taken from the owner's other IRAs, allowing the IRA annuity with the living benefit time to grow until the owner decides to take distributions

Product considerations

- Excess withdrawals will reduce future guaranteed income
- Any withdrawals will reduce the guaranteed death benefits under the contract

Steps

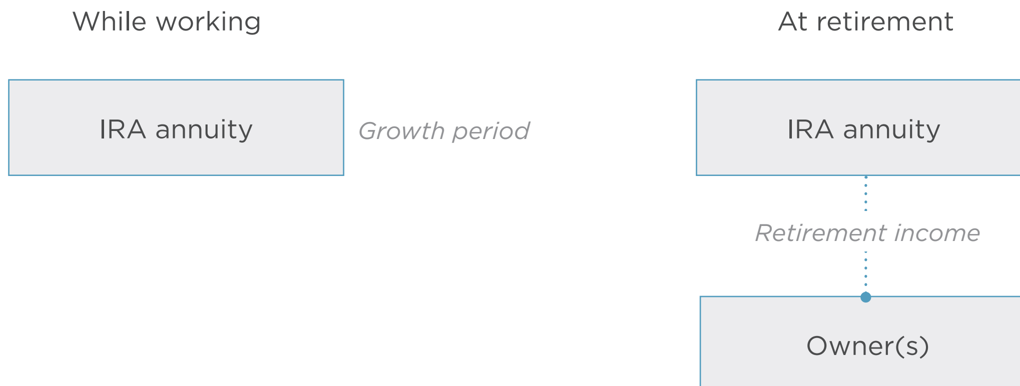
- Within five to 10 years of retirement, transfer the current IRA or qualified plan assets to an IRA annuity with a living benefit

- Qualified plan balances may be used to fund an IRA annuity with living benefit contract via a rollover; this is generally done after a participant separates from service of the sponsoring employer
- Note that some plans also allow for in-service distributions while the employee is still working

Structure

- The **owner** is the IRA account holder (can have only one owner on an IRA contract)
- The **annuitant** is the same as the owner; if the joint life option feature is selected, the spouse must be named as the co-annuitant
- **Primary beneficiary** — If the joint life income feature is chosen, both spouses must be primary beneficiaries; otherwise, the owner may name whoever they would like as beneficiary, such as their child(ren), a trust or a charity
- **Contingent beneficiary** — Whoever the account holder names, usually their child(ren) or a trust, will receive something only if there are no primary beneficiaries remaining

How it works



Target audience: *clients five to 10 years away from retirement who will use the IRA assets for retirement income*

Income planning with a qualified plan-owned deferred annuity

Concept

Small-business owners, such as doctors, lawyers and independent sales consultants, can purchase a deferred annuity with a living benefit in their qualified plan. The annuity can then be distributed in kind to the participant at retirement or stay in the plan and make payments.

Benefit

Use a qualified plan-owned annuity for growth now (cash value and benefit base) and for guaranteed income later.

Potential qualified plans

1) Small qualified plans — one to two participants — in which an annuity is the individual account balance vehicle:
   - Profit sharing
   - 401(k)/Solo 401(k)
2) Small investment pool qualified plans — one to two participants — in which an annuity is an investment in the plans' investment pool:
   - Defined benefit
   - Pooled profit sharing plans
   - Money purchase plans
3) SEP and SIMPLE IRA plans

Tax considerations

- The plan is designed for (and the plan document will allow) an in-kind IRA rollover of the annuity at retirement
- Unless there are nondeductible contributions in the IRA, all distributions received from an IRA will be taxed as ordinary income in the year received, and the balance will receive tax deferral
- If the IRA annuity with a living benefit is the only IRA, then distributions may be delayed only until RMDs are required at age 72
- If the IRA owner has multiple IRAs, then distributions from the IRA annuity with a living benefit can be avoided if the full RMD amounts for all the client's nonannuitized IRAs are taken from the owner's other IRAs, allowing the IRA annuity with the living benefit time to grow until the owner decides to take distributions

Product considerations

- Excess withdrawals will reduce future guaranteed income
- Any withdrawals will reduce the guaranteed death benefits under the contract

Steps

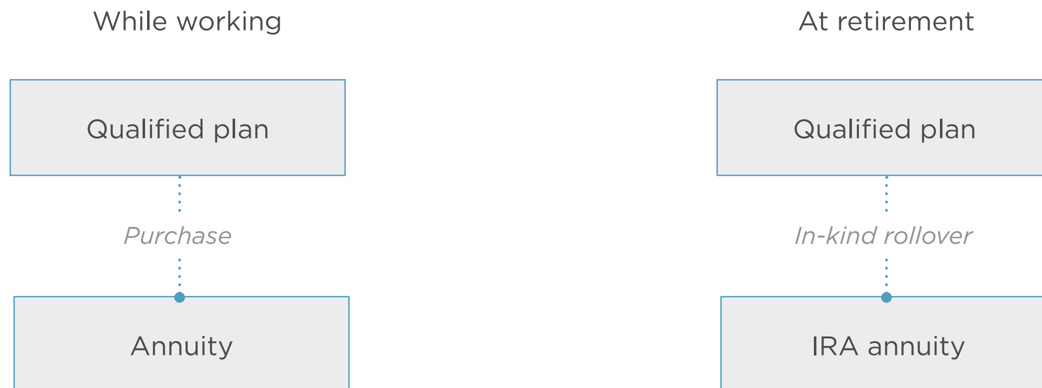
- Consult with the plan administrator and refer to the plan document to identify a suitable qualified plan (this strategy works best with a one-participant plan, or two participants if they're married to each other, and it can even work for small defined-benefit plans)
- The qualified plan purchases an annuity with an income benefit for the advantage of the plan participant
- At retirement, the plan does an in-kind IRA rollover of the annuity policy to the plan participant
- The participant may take withdrawals for retirement income from the now-IRA annuity

continues >>

Structure

- The **owner** is the qualified plan (unless it is a SEP IRA or SIMPLE IRA)
- The **annuitant** is the plan participant, and the co-annuitant may be the participant's spouse (if married and the joint life option is elected)
- The **primary beneficiary** is usually the plan, but if the joint life option is selected, it will be the plan participant's spouse
- **Contingent beneficiary** — Whoever the account holder names, usually their child(ren) or a trust; the contingent beneficiary will receive something only if there are no primary beneficiaries

How it works



Target audience: *small-business owners, sole-practitioner doctors, lawyers and sales consultants who are interested in converting accumulation assets into income assets*

Income planning with an IRA immediate annuity

Concept

This strategy is for investors who want a source of retirement income they cannot outlive and the potential for that income to increase over time by creating multiple IRA buckets.

Benefits

Establish a reliable current income with an immediate annuity and comply with the RMD requirements while growing the living benefit in a deferred annuity for future income.

Tax considerations

- Required minimum distributions (RMDs) must be taken by April 1 of the year after the IRA owner turns 72
- Cumulative RMD amounts calculated for each nonannuitized IRA may be taken from any one or combination of those IRAs
- IRA immediate annuity payments may not be used to satisfy the RMDs for other (nonannuitized) IRAs after the year of annuitization
- Clients can use a trustee-to-trustee transfer or rollover to separate IRA funds into more than one account
- A direct trustee-to-trustee transfer should be used whenever possible
- Unless nondeductible contributions have been made, all funds received from all IRA annuity contracts will be taxed as ordinary income

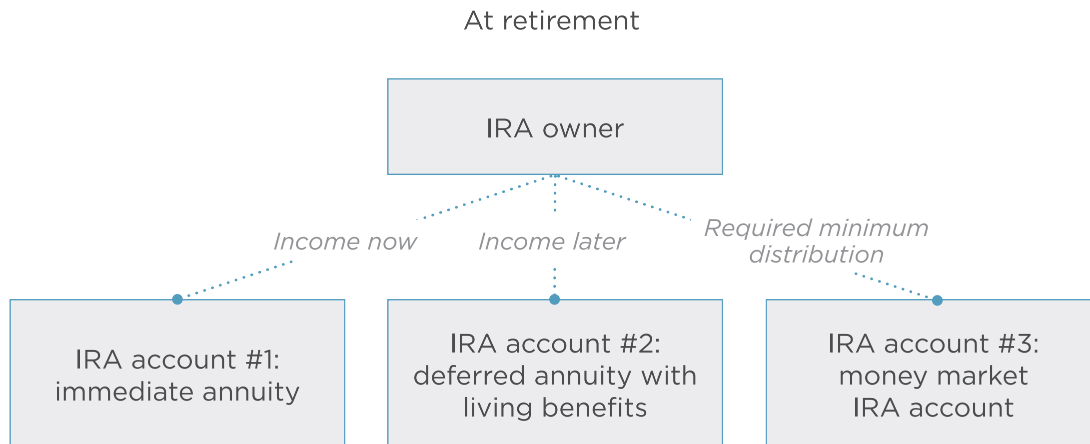
Product considerations

Withdrawals from a deferred IRA annuity with a living benefit, even if taken to satisfy RMD requirements, can lock in payout percentages and halt guaranteed growth.

Steps

- Account 1: "Income now" bucket is placed in an IRA immediate annuity
- Account 2: "Income later" bucket is placed in an IRA deferred annuity with a living benefit
- Account 3: "RMD" bucket is placed in a money market IRA that is sufficient to cover the projected RMDs for the combined IRA amounts in accounts 2 and 3 for a while; this delays having to take an RMD amount out of account 2 that would otherwise lock in payout percentages and stop guaranteed growth

How it works



Target audience: *investors who want a source of retirement income they cannot outlive and the potential for that income to increase over time*

Life insurance-covered Roth conversion: creating tax-free income for life

Concept

Have the surviving spouse convert a traditional IRA to a Roth IRA and use life insurance death benefit proceeds to pay the income tax on the conversion.

Benefits

A Roth IRA annuity with living benefits can provide tax-free income that cannot be outlived to the surviving spouse of an IRA owner.

A Roth IRA is not subject to RMD rules during the lifetime of the person who established it.

Tax considerations

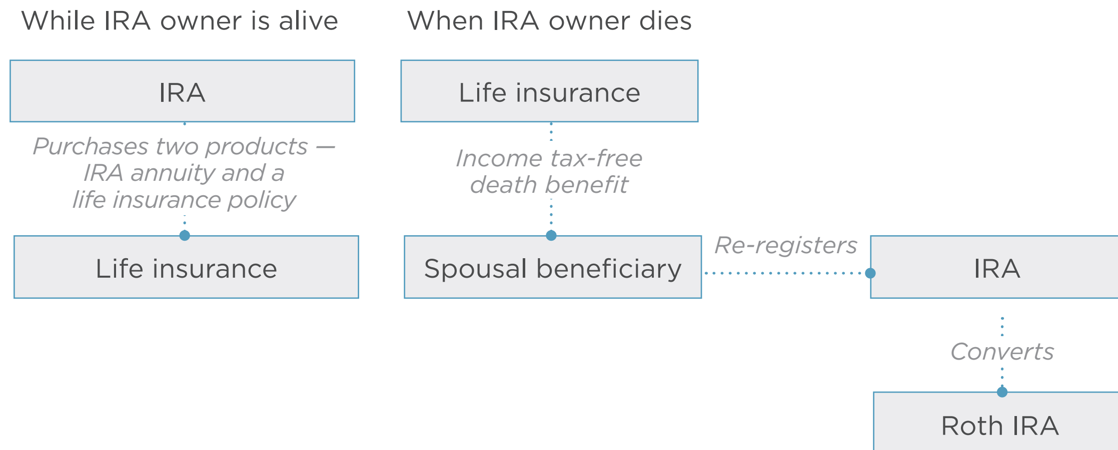
- When converting from a traditional IRA to a Roth IRA, the converted amount will be taxed as ordinary income
- When paying these taxes, it is advantageous to pay the taxes from a source other than the IRA being converted to avoid the 10% tax penalty on premature distributions if the IRA owner (surviving spouse) is under age 59½ at the time of conversion
- Withdrawals of converted amounts after the date of conversion are potentially subject to the 10% tax penalty on premature distributions unless the Roth IRA owner is over age 59½ or it has been more than five years from the year of conversion
- When properly structured, life insurance death benefit proceeds are received income tax free by the beneficiary
- A spouse has the right to re-register the IRA into his/her name at the death of the IRA owner; this may be done at any time after death because there is no time limit on such a transaction; the surviving spouse would probably want to convert the IRA asset to the Roth soon after the death of the IRA owner because future growth in the traditional IRA will increase the taxes due at the time of conversion
- Distributions of gain from a Roth IRA are received income tax free if the Roth IRA owner is over age 59½ and it is beyond five years from the first funding of any current Roth IRA of the owner

Steps

- The client purchases a deferred IRA annuity with a joint life income benefit using traditional IRA assets; the joint life option means the same level of income is guaranteed until the second spouse passes away

- The IRA owner purchases a life insurance policy on his or her own life and names the spouse as beneficiary (the IRA owner must medically qualify); please note this life insurance policy is purchased outside the IRA with after-tax funds; life insurance is not a permissible investment product for IRAs
- Upon the IRA owner's death, the surviving spouse re-registers the IRA into their own name and collects the income tax-free death benefit proceeds from the life policy
- The surviving spouse can convert the entire IRA annuity to a Roth IRA annuity and use the life insurance proceeds to pay the income taxes created by the Roth conversion; the annuity product can stay the same, because it changed from a traditional to a Roth IRA
- The newly converted Roth IRA deferred annuity with a living benefit rider can provide potentially tax-free guaranteed lifetime income for the surviving spouse; please note the age 59½ and five-year holding requirements mentioned earlier for gains from the Roth IRA to be received income tax free
- Any funds remaining in the Roth IRA annuity at the death of the second spouse may be left to heirs

How it works



Target audience: *clients expressing concerns about where tax rates are headed; the IRA owner would need to be healthy enough to qualify for life insurance*

Spousal inherited IRA bucket approach: income for a younger surviving spouse

Concept

Provide income and growth potential using an account bucket approach for a surviving spouse under age 59½ after the death of the IRA owner spouse.

Benefit

Avoid the 10% tax on distributions taken by the surviving spouse before age 59½ and grow income for the surviving spouse's future retirement income.

Tax considerations

- There is no 10% premature distribution tax on funds received from an inherited IRA
- All amounts received from the inherited IRA and/or re-registered IRA are treated as ordinary income to the surviving spouse
- RMDs for the surviving spouse under an inherited IRA must commence no later than when the deceased spouse would have attained age 72
- An inherited IRA may be re-registered into the surviving spouse's name at any time
- If the surviving spouse has re-registered the inherited IRA into his/her own name and takes a distribution from this re-registered IRA while under age 59½, that distribution will trigger the 10% premature distribution tax

Steps

- Surviving spouse purchases an immediate annuity product for income now as a spousal inherited IRA, if under age 59½ (Bucket 1)
- Surviving spouse purchases a deferred annuity with a living benefit product for income later as their own IRA (Bucket 2)
- Surviving spouse creates a liquidity bucket for emergency needs in a cash-equivalent account, such as a money market as a spousal inherited IRA, if under age 59½ (Bucket 3)

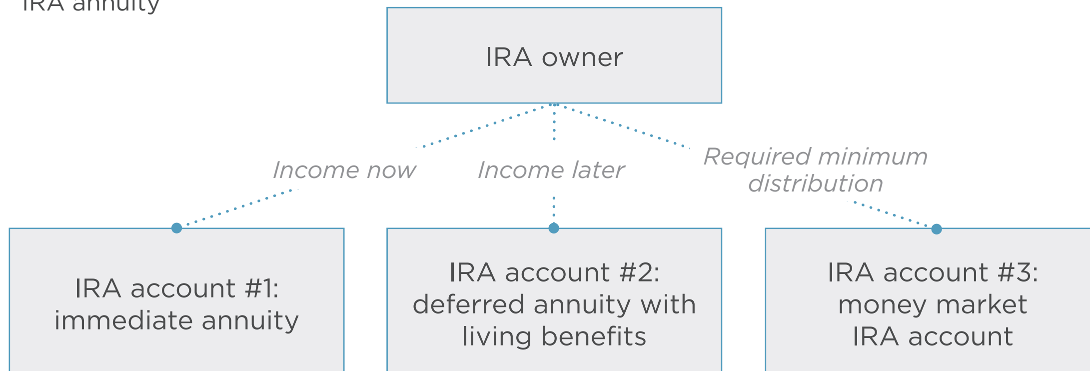
Structure of the three-bucket approach:

- **Bucket 1** for income now
  - Product — Immediate annuity
  - Ownership — Spousal inherited IRA (example: John Doe, deceased FBO Sally Doe, spouse)
  - Annuitant — Surviving spouse
  - Beneficiary — Whoever the surviving spouse chooses; usually will be children as primary beneficiaries and possibly a trust as a contingent beneficiary
  - There are no premature distribution penalties because this annuity is titled as an inherited IRA annuity

- **Bucket 2** for income later
  - Product — Deferred annuity with living benefit
  - Ownership — The annuity is titled as the surviving spouse's own IRA to provide income after the surviving spouse turns 59½
  - Annuitant — Surviving spouse
  - Beneficiary — Whoever the surviving spouse chooses, usually children as primary beneficiaries and possibly a trust as a contingent beneficiary

- **Bucket 3** for emergency needs
  - Product — Liquidity account (money market, bond fund, bank account, etc.)
  - Ownership — Spousal inherited IRA
  - Beneficiary — Whoever the surviving spouse names
  - This will avoid having to take money from Bucket 2, so the deferred annuity can grow its living benefit and avoid the premature distribution penalty if money is needed prior to age 59½

How it works



Target audience: *a surviving spouse who is under age 59½ and who has inherited qualified money*

Nonqualified stretch annuity exchange to a new deferred annuity

Concept

Exchange an inherited nonqualified annuity that is being stretched to a new deferred annuity and get death benefit protection on the beneficial owner as annuitant.

Benefits

This concept utilizes a new deferred annuity product to stretch an inherited nonqualified deferred annuity and receive death benefit protection on the beneficial owner's life (the beneficial owner is listed as annuitant on the new policy).

Spousal protection death benefit features are available for newly issued beneficial annuities as well, further protecting the inheritance from market fluctuations if the beneficial owner is married and either spouse passed away in a down market. The successor beneficiary finishes the extended payment stream at a potentially stepped-up death benefit value.

A stretch schedule is a systematic withdrawal over life expectancy, meaning the beneficial owner can take more than the life expectancy-based payment if needed.

Tax considerations

- Distributions from an inherited nonqualified annuity come from gain first and are income taxable to the beneficiary as ordinary income
- There is no 10% tax penalty on premature distributions from inherited nonqualified annuities
- The calculation methodology for determining the required minimum distribution from the inherited nonqualified deferred annuity is to divide the prior year December 31 value of the annuity by the appropriate life expectancy factor
- The first minimum life expectancy distribution must be taken within one year of the owner's death and then annually thereafter
- The beneficiary establishes their initial life expectancy using the Single Life table then subtracts one from the prior year life expectancy factor for every year thereafter
- The beneficiary's age for determining their initial life expectancy is determined as of December 31 of the first distribution year
- The Single Life table may be found in IRS Publication 590

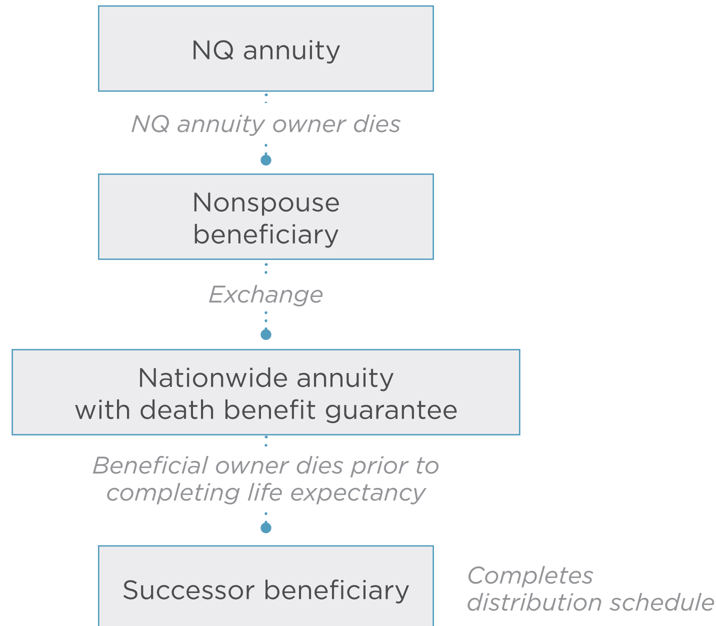
Product limitations

Income benefit riders are not available on inherited nonqualified deferred annuities.

Steps

- The beneficiary completes paperwork exchanging the inherited nonqualified annuity to Nationwide
- The beneficial owner continues to take the required distributions based on his or her life expectancy
- Upon the death of the beneficial owner, the successor beneficiary finishes the beneficial owner's stretch schedule at a potentially increased death benefit value if the beneficial owner dies prior to the completion of the stretch schedule

How it works



Target audience: *beneficiaries seeking to minimize the yearly tax hit of the required beneficial distributions and who want to protect the assets for their own successor beneficiaries*

Inherited IRA transfer to a new deferred annuity

Concept

Transfer an inherited IRA to a new Nationwide deferred annuity.

There are three specific opportunities for this concept:

1) **IRA owner death prior to 2020:** Inherited IRA transfer to a new deferred annuity to continue stretch

2) **IRA owner death in 2020 or thereafter:** Inherited IRA transfer to a new deferred annuity subject to the 10-year rule

3) **IRA owner death in 2020 or thereafter:** Inherited IRA transfer to a new deferred annuity to stretch if the beneficiary is eligible

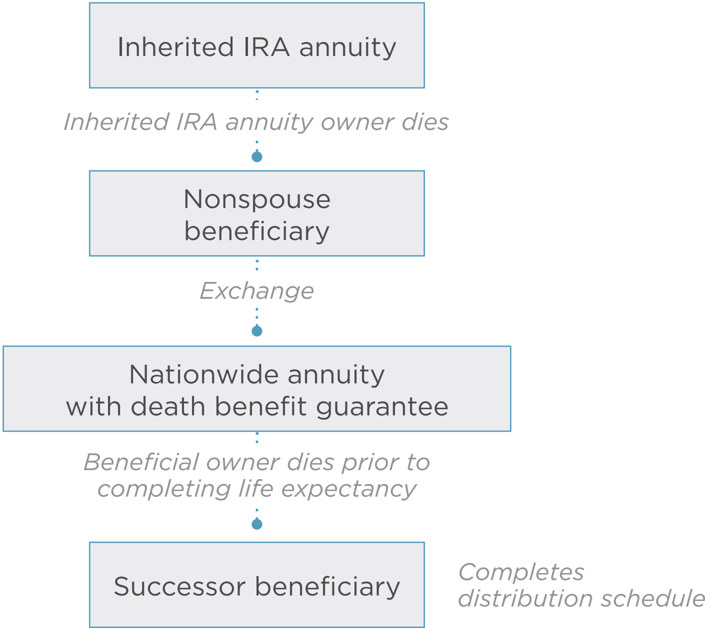
Benefits

- Death benefit protection offered on newly issued inherited IRA annuities
- Spousal death benefit features are available
- Death benefit protection is on the life of the beneficial owner/annuitant
- Living benefits are not available

Tax considerations

- For most individual nonspouse beneficiaries, the payout requirement is 10 years when the owner dies in 2020 or thereafter, with some exceptions
- The account must be liquidated by 12/31 of the 10th year after the owner's death; the 10-year rule does not require annual or periodic distributions
- This also applies to trusts that are considered designated beneficiaries
- Exceptions permitting life expectancy-based payouts:
  - Spouses
  - Minors
  - Disability
  - Chronic illness
  - Less than 10 years younger
- Life expectancy payouts may continue where owner died prior to 2020

How it works



Target audience: *beneficiaries seeking to minimize the yearly tax hit of the required beneficial distributions and who want to protect the assets for their own successor beneficiaries*

Partial 1035 exchanges between deferred nonqualified annuities

Concept

By splitting one deferred nonqualified annuity contract into two or more contracts, faster access to cost basis may be achieved for clients who express a future income need.

Benefits

This technique provides the potential ability to lower taxes on retirement income distributions from nonqualified annuities with large internal gains.

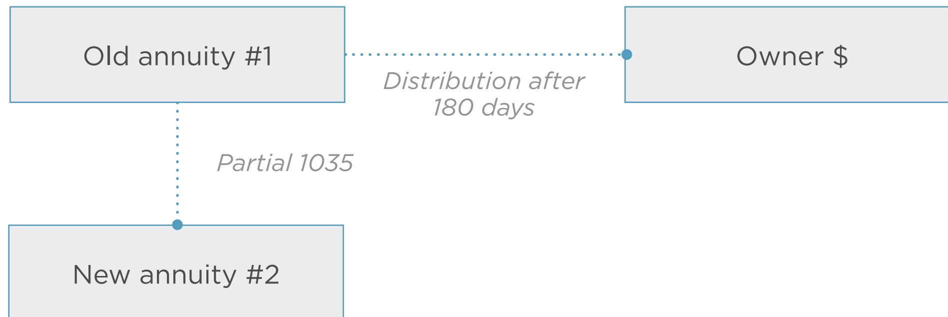
Tax considerations

- Taxable gains are distributed from deferred annuities before nontaxable return of basis is distributed
- Distributions of gains taken from a deferred annuity prior to age 59½ will be assessed a 10% tax for premature distribution unless an exception applies
- All partial exchanges of annuities are prorated, meaning the exchanged amount will have the same ratio of cost basis to gain as the source contract
- To get separate cost basis treatment on the deferred annuities that were part of the partial exchange, no distributions should be taken from the deferred annuities that were part of the partial exchange within 180 days of the partial exchange (see Revenue Procedure 2011-38)
- If the 180-day period is violated by taking a distribution from one or more of the deferred annuities that were part of the partial exchange, then the deferred annuities that were part of the partial exchange will be aggregated for determining the taxable amount of the distribution (see Revenue Procedure 2011-38)

Steps

- Review existing annuities of those clients approaching 59½ or older to determine which have substantial gains
- Discuss with those annuity owners their anticipated withdrawals from the annuities and explain how the partial 1035 exchange rules may allow them to better manage their income taxes on their nonqualified annuity withdrawals
- Do a partial 1035 from the existing annuity into a new annuity; the cost basis and gain will be prorated between the old and new annuity
- To avoid aggregation, wait until at least day 181 after the partial exchange before taking any withdrawals from either annuity that was part of the partial exchange

How it works



Target audience: *owners of nonqualified deferred annuities who express a future income need from contracts with large amounts of tax-deferred gains*

Partial exchanges from a nonqualified deferred annuity to an immediate annuity

Concept

Create a tax-advantaged income stream with an immediate annuity funded via partial exchanges from a deferred annuity.

Benefits

This method allows an annuity owner to dial in a known payment need for wealth transfer, baseline income or gifting from a deferred annuity, and it eliminates having to choose between "all or nothing" annuitization. It also preserves some measure of liquidity from the deferred annuity in case of a cash need.

Exclusion ratio treatment of the immediate annuity payments means less tax is paid on the same amount of cash flow as compared with withdrawals from a deferred annuity, which follow the gains-first principle.

Tax considerations

Immediate annuity tax rules

- Payments from an immediate annuity are composed of a portion of cost basis and a portion of gain
- Distributions of deferred gain from an immediate annuity (meaning the immediate annuity was funded via 1035 exchange from a deferred annuity that contained deferred gain) prior to age 59½ will be assessed a 10% tax for premature distribution unless an exception such as lifetime annuitization applies
- If the first payment from the immediate annuity, funded by a partial exchange from a deferred annuity, is received within 180 days of the partial exchange, then any life-based payout option or term-certain-only payout option of 10 years or greater avoids aggregation
- If the first payment from the immediate annuity, funded by a partial exchange from a deferred annuity, is received later than 180 days after the partial exchange, then any payout option avoids aggregation
- It may be possible, if the current deferred annuity carrier allows, to annuitize a portion of the current deferred annuity instead of exchanging a portion of the deferred annuity into an immediate annuity; the taxation rules of partial annuitizations follow the payout rules mentioned above

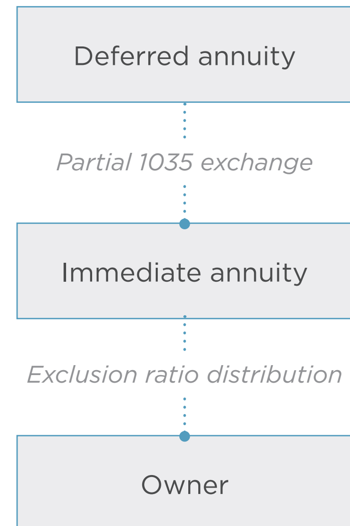
Deferred annuity tax rules

- Taxable gains are distributed from deferred annuities before nontaxable return of basis is distributed
- Distributions of gain taken from a deferred annuity contract prior to age 59½ will be assessed a 10% tax for premature distribution unless an exception applies
- All partial exchanges of annuity contracts are prorated, meaning the exchanged amount will have the same ratio of cost basis and gain as the source contract
- Revenue Procedure 2011-38 provides the ability to split one annuity into two (or more) annuities and treat each one separately for income tax purposes after 180 days from the date of the partial exchange

Steps

- Commence a partial 1035 exchange from the existing deferred annuity into an immediate annuity; the cost basis and gain will be prorated between the old and new annuities
- Payments from the immediate annuity will have exclusion ratio treatment if the payment is life based or a 10-year term certain or greater
- Payments from the immediate annuity will have exclusion ratio treatment regardless of what the payout option is if payments begin later than 180 days after the date of the partial exchange
- The amount remaining in the source deferred annuity may be accessed for additional cash needs; however, withdrawals from the source deferred annuity should occur later than 180 days after the date of the partial exchange to avoid the negative tax ramifications of aggregation

How it works



Target audience: *owners of nonqualified deferred annuities who express a future income need from contracts with large amounts of tax-deferred gains*

Charitable gift annuity (CGA) “reinsurance”

Concept

Charitable gift annuity (CGA) reinsurance permits charitable organizations to minimize cash flow and longevity risk while providing donors with cash flow certainty, as long as there is an acceptable spread between what the charity has to invest in the commercial immediate annuity and the amount of the charitable donation. This may not always be the case.

Benefits

This technique allows a charity to transfer donor longevity risks and investment risks to a commercial insurance company through the use of a commercial immediate annuity. The CGA provides an income for the donor that he or she cannot outlive. This is essentially a self-completing transaction for the charity. It is also beneficial for the donor in that payments are guaranteed from the insurance company, meaning that the charity will have the cash flow necessary to live up to its CGA promise to the donor.

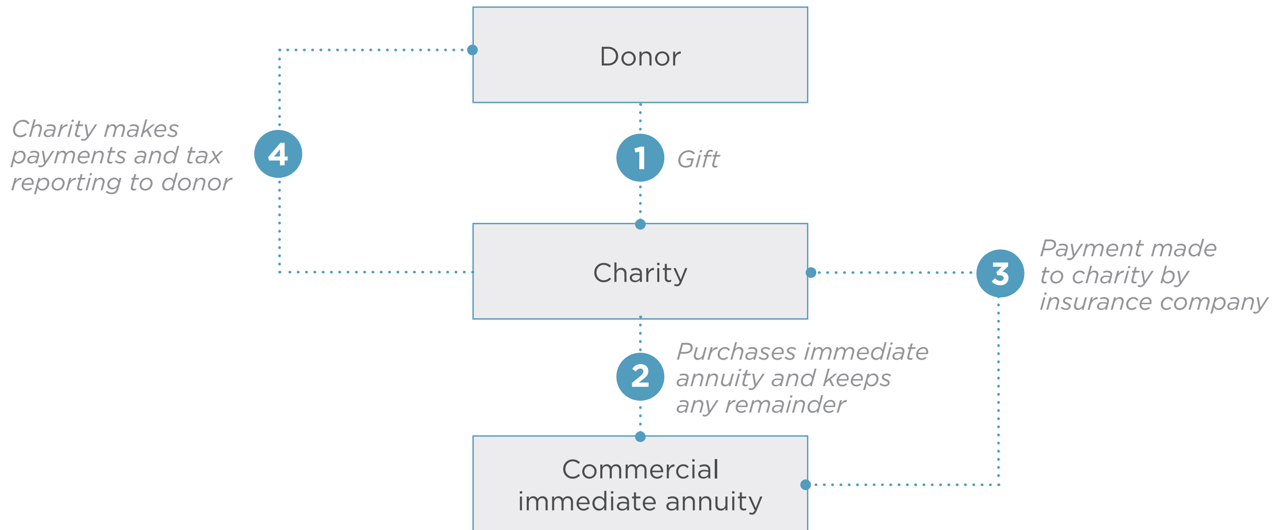
Tax considerations

- The donor is permitted to give away highly appreciated property without having to pay taxes currently; instead, the donor pays taxes over time as each payment from the CGA is received
- A current income tax deduction may be generated for the donor at the time of the gift to the charity if the present value of the annuity is less than the value of the property transferred to the charity
- This technique may be an effective tool for smaller charities that are concerned that a donor may outlive his or her life expectancy, thereby requiring greater payouts than anticipated

Steps

- A donor makes a gift of cash or other property to charity and may receive a current income tax deduction
- The charity takes part of the contribution to purchase a commercial immediate annuity on the life of the donor
- The donor receives an income for the term of the CGA
- The CGA is “backed” by the immediate annuity contract
- The charity may take the difference between the amount of the gift and the purchase price of the immediate annuity and use it for programming or operations

How it works



Target audience: *charitable organizations and/or donors looking for ways to provide cash flow certainty for a charitable gift annuity promise*

Social Security benefits maximization

Concept

In a married couple, the higher-earning spouse purchases an immediate annuity for income between ages 62 and 70 instead of taking Social Security benefits at age 62. The Social Security benefit grows for both retirement income and survivor benefit purposes.

Benefits

Delaying taking Social Security benefits can result in as much as an 8% increase per year in income if recipients wait until age 70 instead of taking Social Security at age 62. This can be very effective if one spouse is many years younger than the other or if longevity is expected. Negative health considerations should also be taken into account because they may make delaying Social Security benefits less attractive.

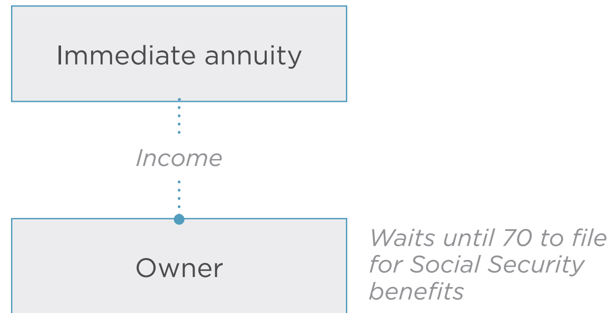
Tax considerations

- Immediate annuity payments will include a portion that is a nontaxable return of basis and a taxable amount made of earnings, if purchased with nonqualified money
- If the immediate annuity is purchased with IRA money, then the full amount of the payment is generally taxable
- Social Security benefits can be taxable, depending on total income

Steps

- The higher-earning spouse purchases an immediate annuity at age 62 by solving for a monthly payment equivalent to their Social Security payout at age 70
- The lower-earning spouse may claim Social Security benefits at age 62
- The higher-earning spouse claims Social Security at age 70

How it works



Target audience: *early retirees, especially those with a significantly younger spouse, who express concern about cash flow after the older spouse passes away*

Gifting

Concept

Clients who are seeking to provide financial assistance to family members for a specific purpose or in a specific amount may purchase an immediate annuity and name an alternate payee and potentially an alternate annuitant. Common uses of the idea include lifetime gifting, education funding and car payments.

Benefits

Use a nonqualified immediate annuity to create cash flow for gifting purposes.

Tax considerations

This strategy is done only with nonqualified funds. The tax considerations are predicated on the titling of the immediate annuity contract; for example, if the contract structure is:

- Mom is the owner
- Daughter is the annuitant
- Daughter is the payee (the payee can be changed by the owner at any time)
- Granddaughter is the beneficiary

Then the tax considerations are:

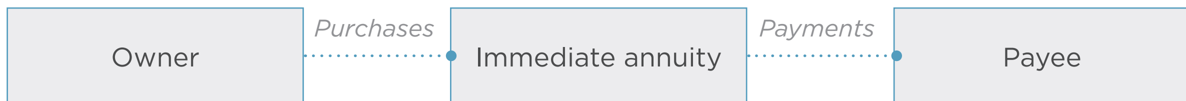
- Mom (owner) receives the income tax reporting from the annuity
- Mom (owner) gets to use exclusion ratio treatment on the payments, and a large portion of the payment may be a nontaxable return of basis
- Gifts are completed when daughter (payee) receives payments, not when mom (owner) purchases the immediate annuity
- The annual gifting exclusion amount and/or lifetime gifting exemption can be used to avoid gift tax
- Mom doesn’t have to get involved with the paper trail of payments because daughter is the payee
- Daughter (annuitant) takes over ownership if mom (owner) dies

- At the death of the daughter (annuitant) and if there is a residual amount under a term-certain or cash-refund payout option still available, the granddaughter (beneficiary) may either:
  - Continue payments at the current level
  - Take a commuted amount
- If the daughter (annuitant) dies before her mom, this would then be a gift of any residual amount from grandmother (owner) to granddaughter (beneficiary), because grandmother (owner) is still alive when the wealth (residual amount) is made available to granddaughter (beneficiary)

Steps

- Determine the need that the payee may have and how much of that need will be funded
- Calculate the income needed for the desired purpose and solve for the amount of cash needed to purchase the immediate annuity

How it works



Target audience: *clients seeking to provide financial assistance to family members for a specific purpose or in a specific amount over time*

Annuity in an irrevocable trust: death benefit protection

Concept

An irrevocable trust purchases a nonqualified deferred annuity for death benefit protection on the surviving spouse's life.

Benefits

Tax deferral: Tax deferral can be of value to an irrevocable trust that is accumulating assets where the trust is the taxpayer because trust taxation, relative to individual taxation, has lower income thresholds to reach the higher ordinary income tax rates.

Income management: An annuity can also help manage any trust provisions regarding mandatory income distributions to certain beneficiaries (typically surviving spouses). This is because the growth in an annuity is generally not considered trust income; therefore, it doesn't have to be distributed to a surviving spouse or other beneficiary who doesn't want income from the trust. In these situations, the surviving spouse usually wants the assets in the trust to go to the trust remainder beneficiaries, who are typically their children.

Beneficiary ownership: The death benefit protections of annuities allow the trust to insulate the trust remainder beneficiaries from loss. In this situation, the trust may consider life insurance as a protection vehicle as well.

The client should consult with an attorney experienced in trust planning to determine how to best accomplish their specific goals.

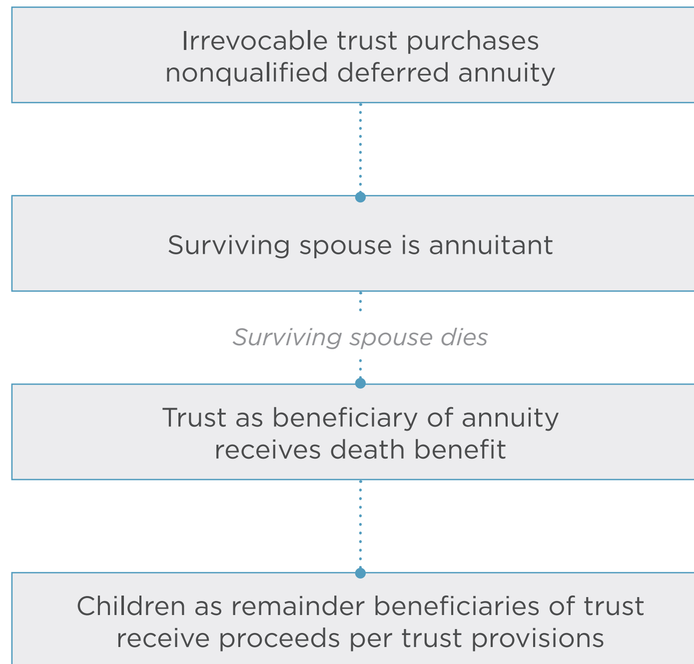
Tax considerations

- In order for a trust to receive tax deferral on annuities owned by the trust, it must be considered as acting as an agent for a natural person; if all the trust beneficiaries are natural people, a trust generally receives tax deferral
- Undistributed growth from a trust-owned annuity is not currently taxed; however, if distributions are taken from the annuity, they will come from gains first and either the trust or trust beneficiaries (if the distribution is passed through to them) will include the annuity distribution as taxable income
- If trust assets are sold to purchase an annuity, the gain on the sale of those assets may be taxable income to the trust
- If distributions are taken from the annuity when the trust is the owner and prior to the death of the annuitant, there may be a 10% premature distribution tax penalty on the taxable portion depending on the age of the trust beneficiaries and/or taxpayer on the distribution
- When the annuitant on a trust-owned annuity dies, a distribution must occur, and the gain in the policy will be taxable when withdrawn
- A change of annuitant on a trust-owned annuity policy forces a payout from the annuity

Steps

- The trustee of the trust uses trust assets to purchase a deferred annuity with the trust as the owner, the surviving spouse as the annuitant and the trust as the beneficiary
- At the surviving spouse's death, the annuity death benefit is paid to the trust as beneficiary of the annuity, and the proceeds are distributed to the beneficiaries of the trust according to the trust provisions

How it works



Target audience: *clients with an existing credit shelter/bypass/B trust who may be interested in exploring options to build trust assets for trust beneficiaries*

Annuity in an irrevocable trust: in-kind distribution

Concept

An irrevocable trust purchases deferred annuity contract(s) with the trust remainder beneficiary(ies) as annuitants. At some point in the future, the annuity policies are distributed in kind to the trust remainder beneficiary(ies).

Benefits

Tax deferral: Tax deferral can be of value to an irrevocable trust that is accumulating assets where the trust is the taxpayer because trust taxation, relative to individual taxation, has lower income thresholds to reach the higher ordinary income tax rates.

Income management: An annuity can also help manage any trust provisions regarding mandatory income distributions to certain beneficiaries (typically surviving spouses). This is because the growth in an annuity is generally not considered trust income; therefore, it doesn't have to be distributed to a surviving spouse or other beneficiary who doesn't want income from the trust. In these situations, the surviving spouse usually wants the assets in the trust to go to the trust remainder beneficiaries, who are typically their children.

Beneficiary ownership: The trust beneficiaries become the owners of the annuity policies, and tax deferral continues. The new owners may name whoever they would like as beneficiary.

The client should consult with an attorney experienced in trust planning to determine how to best accomplish their specific goals.

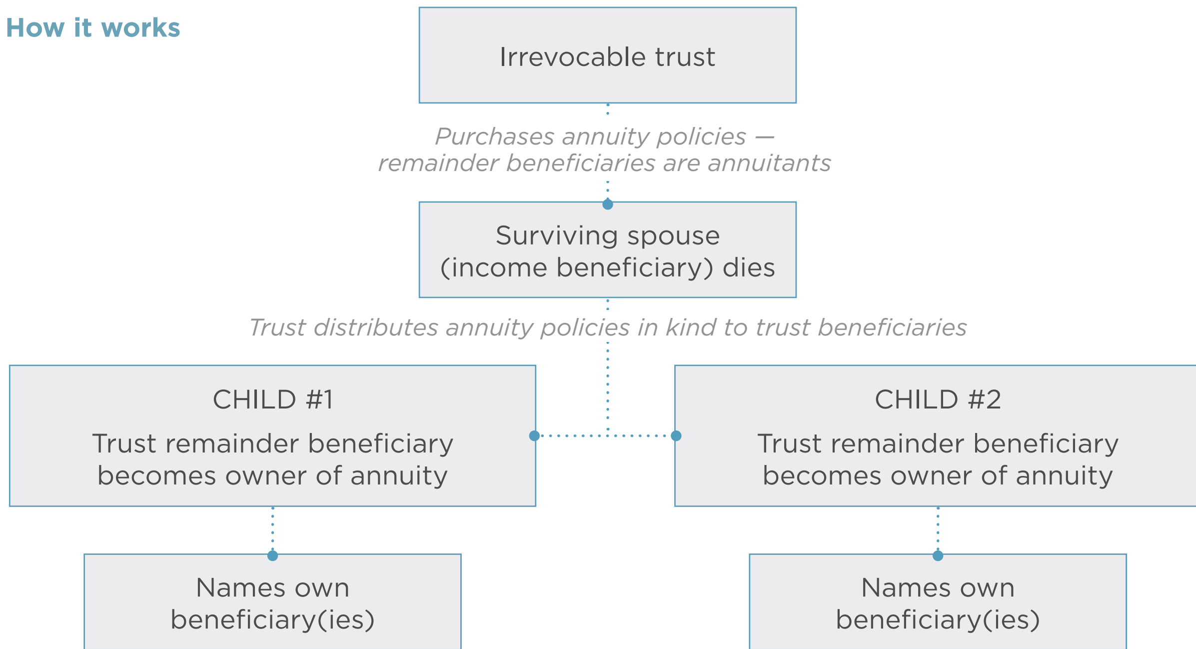
Tax considerations

- In order for a trust to receive tax deferral on annuities owned by the trust, it must be considered as acting as an agent for a natural person; if all the trust beneficiaries are natural people, a trust generally receives tax deferral
- Unless taxable income earned by a trust is distributed to a beneficiary of the trust in the same tax year, the trust pays income taxes on that taxable income
- If trust assets are sold to purchase an annuity, the gain on the sale of those assets may be taxable income to the trust
- In order to avoid the 10% premature distribution tax penalty, the remainder beneficiaries of the trust should plan to defer distributions of income from the annuity until after age 59½ or to pass the annuity death benefit to their heirs
- The in-kind distribution (ownership change) of a trust-owned annuity policy to trust beneficiaries is not an income-taxable event if the trust beneficiary is the annuitant on the policy; see PLR 199905015

Steps

- The trustee uses trust assets to purchase separate annuity contracts with the trust as owner, the remainder beneficiaries of the trust as annuitants and the trust as the beneficiary of the annuity policies
- The trustee may distribute each annuity contract to each respective trust remainder beneficiary in kind upon a triggering event according to the trust provisions (such as the death of the surviving spouse) without incurring gift or income taxes, as long as the trust beneficiary taking over ownership of the respective policies is the annuitant on that policy
- The annuities will remain income tax deferred until the death of the respective trust beneficiary as owner and annuitant or until voluntary distributions are made from the contracts

How it works



Target audience: *trusts with assets that are primarily for the future retirement income needs of the remainder beneficiaries*

Annuity in an irrevocable trust: lifetime gift to reduce the estate

Concept

An individual makes a gift to an irrevocable trust, and the trust purchases a deferred annuity for tax deferral and death benefit protection.

Benefits

Making a gift to an irrevocable trust during the grantor's lifetime can remove the gifted assets and future appreciation from the grantor's estate for estate tax purposes.

The trust purchases a deferred annuity for tax-deferred accumulation potential and death benefit protection.

Tax considerations

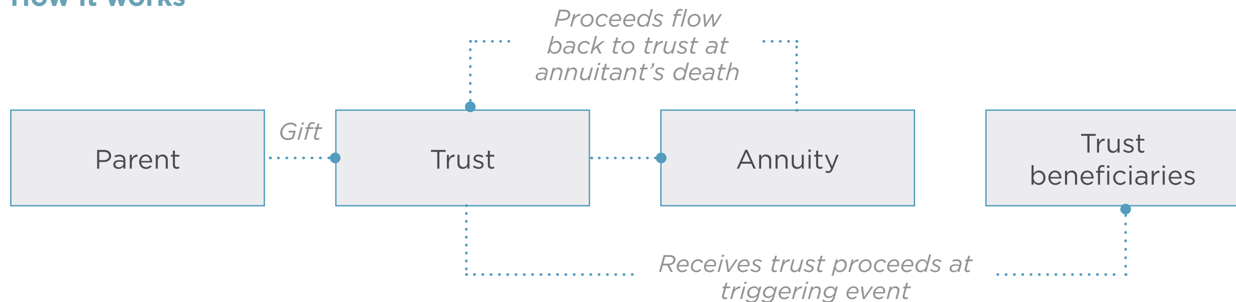
- When assets are given to a trust, either or both the annual exclusion amount (typically requires the trust beneficiary to sign off via a Crummey letter) or lifetime gifting exemption amount may be used to potentially offset gift taxes that may be due
  - The gift tax annual exclusion amount is $15,000 per donor per donee in 2020
  - The lifetime gifting exemption for an individual is $11.58 million in 2020
- Once this gift is made, it cannot be undone or changed; the grantor loses access to the gifted funds and future appreciation
- An annuity that is owned by a trust receives tax deferral if the trust can be considered as acting as the agent for a natural person
- If distributions are taken from the annuity, then gains will be distributed first and will be taxable either to the trust or a trust beneficiary if the distribution is passed through to a trust beneficiary
- The taxable portion of annuity distributions is taxed as ordinary income
- If distributions are taken from the annuity prior to the death of the annuitant, there may be a 10% premature distribution tax on the taxable portion, depending on the age of the trust beneficiaries and/or taxpayer on the distribution
- Upon the death of the annuitant, the annuity must pay out to the named beneficiary; in most cases, the trust is the beneficiary of the annuity it owns; when a trust is the beneficiary of an annuity and the trust takes the payout from the policy, either the trust is the taxpayer on the gains in the policy or, if the trust distributes the annuity proceeds to trust beneficiaries, they will pay the income tax at their own individual tax rates

- When a trust is the beneficiary of a nonqualified deferred annuity, the entire amount in the contract must be distributed no later than five years from the death of the annuitant; a trust may not utilize the life expectancy or spousal re-registration options
- There is no 10% premature distribution tax that applies to distributions after the annuitant dies
- If the annuitant on a trust-owned annuity is changed, that annuitant change will be treated as if the annuitant had died and all the gain in the policy will become taxable income

Steps

- A gift is made to the trust, and the trustee purchases an annuity contract
- The owner and beneficiary are typically the trust
- The spouse who is likely to live the longest is typically named as annuitant; only one annuitant is permitted on an annuity owned by an irrevocable trust
- At the death of the annuitant, a death benefit is paid to the trust
- Annuity death benefit proceeds may be given to heirs through the trust depending on the distribution provisions in the trust, or the annuity proceeds are reinvested by the trust

How it works



Target audience: *clients utilizing estate-planning techniques to provide for heirs and remove assets from their taxable estate; typically, these clients have assets above current estate tax exemption levels*

Annuity in a revocable trust: trust as beneficiary

Concept

A revocable trust purchases a deferred annuity for death benefit protection, and the trust is named as the annuity beneficiary.

Benefits

A revocable trust can provide control and consolidation of assets while the grantor is alive, and privacy (through probate avoidance) and personalized distribution options after death. An annuity owned by a revocable trust can provide tax deferral while the annuitant (who is usually the grantor of the trust) is alive and death benefit protection when the annuitant passes. As with any revocable trust, the grantor can take a distribution from the policy at any time if needed. This distribution may be taxable if there is gain in the policy.

Tax considerations

- Because revocable trusts are grantor trusts for taxation purposes, an annuity owned by a revocable trust receives tax deferral because of the trust's grantor trust tax status
- The grantor of the revocable trust will be responsible for any income tax incurred if taxable distributions are taken from the annuity while the grantor is alive
- When the annuitant dies and the trust is named as beneficiary on the nonqualified deferred annuity, all funds must be distributed from the annuity within five years from the date of the annuitant's death
- A change of annuitant on a trust-owned annuity policy forces a payout from the annuity

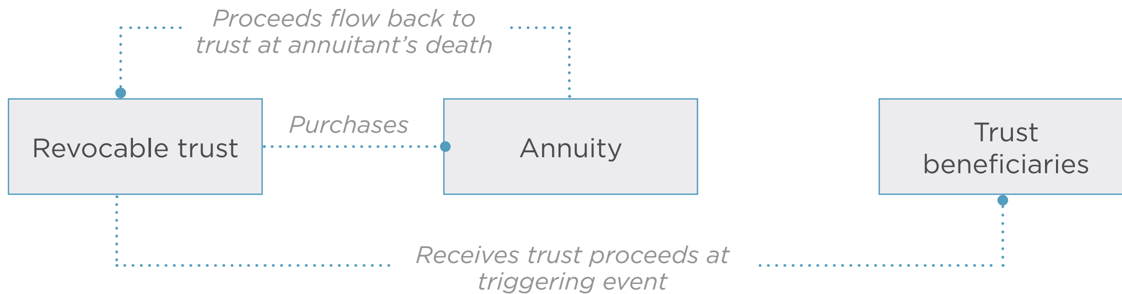
Steps

- The revocable trust purchases an annuity on the grantor
- The trust is the primary beneficiary of the annuity

Example structure:

- Owner = John Doe revocable trust
- Annuitant = John Doe
- Primary beneficiary = John Doe revocable trust

How it works



Target audience: *individuals who have assets in a revocable trust who are looking for tax-deferred accumulation with protection*

Annuity in a revocable trust: spouse as beneficiary

Concept

A revocable trust purchases a deferred annuity, but instead of naming the trust as beneficiary, the grantor's spouse is named as the annuity's beneficiary, and a spousal death benefit feature is added.

Benefits

This concept can provide the potential for death benefit protection on both spouses, as well as the ability to extend tax deferral with the spousal re-registration privilege. However, if the grantor passes away before the spouse, the grantor would lose the control at his/her death that naming the trust as beneficiary would have provided. Depending on family dynamics and objectives, this may not be much of an issue, but it should be understood.

Tax considerations

- The grantor of the revocable trust will be responsible for any income tax incurred if taxable distributions are taken from the annuity while the grantor is alive
- The annuity is owned by the revocable trust; if the annuitant is changed, the change will be treated as if the annuitant died, and all the gain in the policy will become income taxable
- Tax deferral will be maintained until the death of the first spouse
- At that time, tax deferral may be extended through the spousal re-registration privilege where the surviving spouse re-registers the contract into his or her own name; when this is done, the trust would cease to be the owner and the surviving spouse would become the new owner

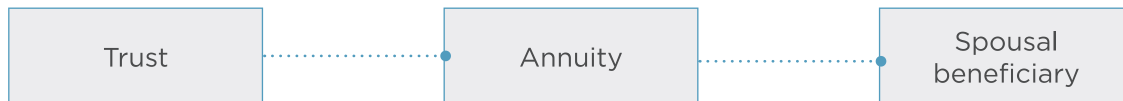
Steps

- The revocable trust purchases a deferred annuity on the grantor
- A spousal death benefit feature is added to the policy

Example structure:

- Owner = John Doe revocable trust
- Annuitant = John Doe
- Co-annuitant = Mary Doe (John's wife)
- Primary beneficiary = Mary Doe
- Primary beneficiary = John Doe
- Contingent beneficiary = John Doe trust

How it works



Target audience: *clients who may simply be trying to bypass probate with the revocable trusts and are leaving all their assets to their surviving spouse; trusts frequently are created to accommodate special circumstances or have very specific payout instructions; such circumstances may not be a good fit for this strategy*

Annuity in a charitable trust: deferred annuity with an income benefit in a CRAT

Concept

A charitable remainder annuity trust (CRAT) purchases a deferred annuity with a living benefit.

Benefits

CRATs provide a fixed-dollar payment to the income beneficiary. The donor receives an income tax deduction for making a gift to the CRAT. The donor will receive a fixed-dollar-amount payment every year from the trust, usually for as long as they live. A deferred annuity with a living benefit may be used to increase the likelihood that the trust always has a guaranteed source of cash flow to make this required payment and that there is money to be left to the charity.

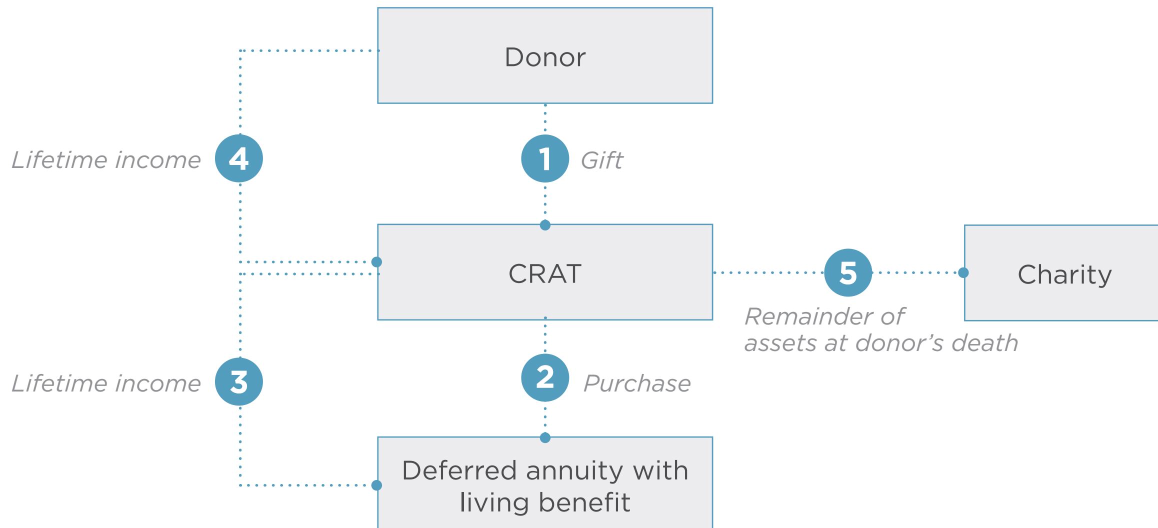
Tax considerations

- CRATs can be very complex, but some general considerations are listed below; CRATs should be established only with the direction of a competent attorney and accountant
- The amount of the income tax deduction will be driven by a combination of the age of the grantor(s) and the IRC 7520 rate in effect at the time of the gift to the trust
- Generally, the younger the grantor(s), the less the deduction will be; the income tax deduction is usually not for the full value of the gift, but is reduced by the value of the donor's retained income interest in the trust
- The grantor will generally fund the trust with highly appreciated capital assets, which would otherwise result in a large capital gains tax for the grantor if sold personally
- The trustee will be able to sell the assets with no capital gains exposure at the time of sale
- When the trust is established and funded, the trust must be actuarially sound; it must pay at least 5% income to the grantor(s) and must leave at least 10% to charity; this calculation must be completed at the inception of the trust and is not required to be repeated
- It is important to note that the charity is not involved in this transaction until the grantor dies; the trustee of the CRAT makes all the decisions with respect to investments and distributions
- Because income payments are made to the donor, usually at least some portion (if not all) of the payments are taxable to the donor; the tax composition of each of the payments will be determined by the trustee based on the types of income received by the trust

Steps

- The grantor establishes the CRAT and funds it with a gift of appreciated assets
- The trustee will then sell the assets or otherwise turn them into income-producing assets; because the trust is charitable in nature, it does not pay income or capital gains tax on the sale of assets
- The trustee may purchase an annuity with an income benefit guarantee to provide a fixed payment that can last for the life of the grantor, assuming there are no excess withdrawals
- Upon the death of the grantor, any assets left in the trust will be paid to the named charitable beneficiary

How it works



Target audience: *clients who may already have a CRAT established and funded but are seeking ways to provide a guaranteed cash flow while potentially increasing the likelihood of leaving trust assets to a charity*

Annuity in a charitable trust: deferred annuity in a NIMCRUT for death benefit and income suppression

Concept

The net income with makeup charitable remainder unitrust (NIMCRUT) purchases a deferred annuity with a death benefit feature.

Benefits

A NIMCRUT is a specific type of CRT that is required to pay the lesser of the unitrust amount (a percentage of trust assets) or trust income. Any deficiency amount that is not paid in any one year is carried over and may be paid (made up) in years for which trust income exceeds the distribution requirement.

An annuity owned by a NIMCRUT enables the trustee and income beneficiaries to control the timing of income and distributions because:

- The inside buildup of annuity contracts is not considered to be distributable earnings of the NIMCRUT and thus does not have to be distributed to the grantor; so if the grantor of the NIMCRUT does not want to take income from the NIMCRUT, having an annuity allows income payments from the NIMCRUT to be suppressed even if the annuity gains in value
- The death benefit protections of the annuity allow the values to be grown and protected for the charitable beneficiary

Tax considerations

- NIMCRUTs can be very complex, but some general considerations are listed below; NIMCRUTs should be established only with the direction of a competent attorney and accountant
- The amount of income tax deduction will be driven by a combination of the age of the grantor(s) and the IRC 7520 rate in effect at the time of the gift to the trust
- Generally, the younger the grantor(s), the less the deduction will be, as compared to a similar gift by an older person to a NIMCRUT with a similar payout rate; the income tax deduction is usually not for the full value of the gift but instead is reduced by the value of the donor’s retained income interest in the trust

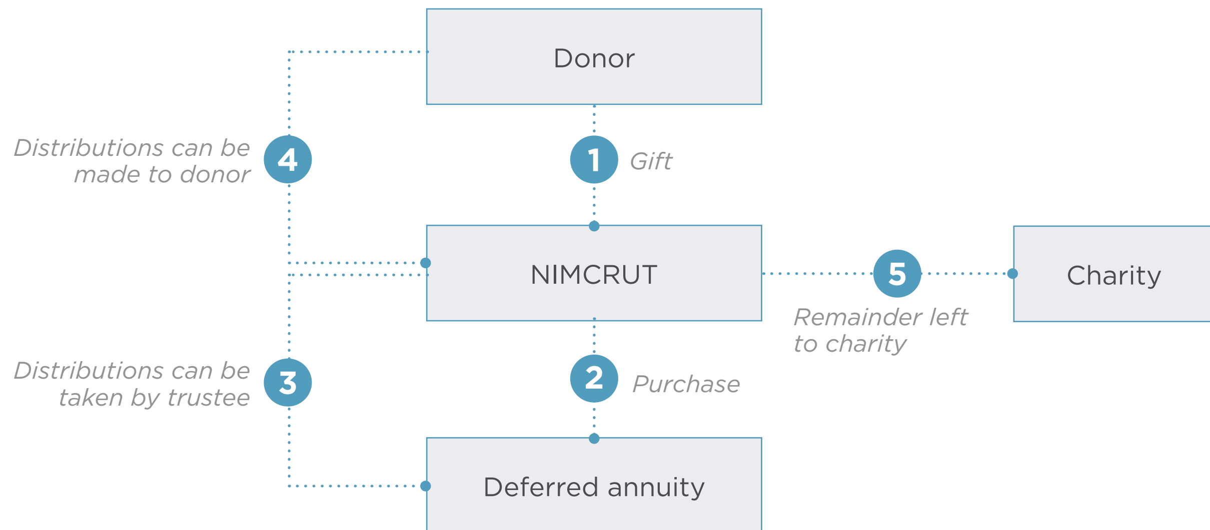
- The grantor will generally fund the trust with highly appreciated capital assets, which would otherwise result in a large capital gains tax for the grantor if sold personally
- The trustee will be able to sell the assets with no capital gains exposure at the time of sale
- When the trust is established and funded, it must be actuarially sound and must leave at least 10% to charity; this calculation must be completed at the inception of the trust and is not required to be repeated
- It is important to note that the charity is not involved in this transaction until the grantor dies; the trustee of the NIMCRUT makes all the decisions with respect to investments and distributions
- If or when income payments are made to the NIMCRUT grantor, usually at least some portion (if not all) of the payments are taxable to the donor; the tax composition of each of the payments will be determined by the trustee

Steps

- Your clients should consult with a competent estate-planning attorney to either draft a NIMCRUT or review an existing one to determine if an annuity is an appropriate investment vehicle; the trust language is important, too, because it defines income and how it will be paid out
- If it is a new NIMCRUT, the donor will give the property to the trust and the trust will sell the property
- The trust will take a portion or all of the sale proceeds and purchase the annuity with the death benefit protection
- The buildup in the annuity will stay in the annuity and suppress the trust income until the trustee begins to take distributions from the annuity to pay to the grantor
- Once the annuity begins making distributions, the trustee will calculate the trust's payout every year based on the NIMCRUT's formula; this allows the trust to distribute the required annual income amount and potentially any excess income
- Upon the death of the annuitant, the death benefit protection will be in place for the charity or other income beneficiary

continues >>

How it works



Target audience: *clients who may already have a NIMCRUT established but are trying to maximize a payout to the charitable beneficiary during a turbulent market environment*

Funding long-term care insurance from a deferred annuity

Concept

Purchase a nonqualified deferred annuity now so that in the future, the annuity's contract value may be 1035-exchanged into a stand-alone long-term care insurance (LTCi) policy.

Benefit

This strategy enables the client to purchase needed LTCi on a tax-advantaged basis. If the client has an annuity that they are not planning to use for income in retirement, this could be a way to pay LTCi premiums without having to come up with money out of pocket. It is also a potential way to use an underperforming annuity to greater overall benefit. Premiums are typically paid one year at a time using partial exchanges from the annuity.

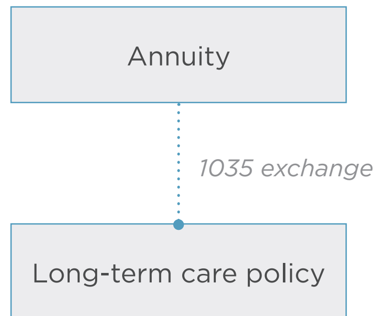
Tax considerations

- It is now possible to undertake a tax-free 1035 exchange from a deferred annuity to an LTCi policy
- This is to be used for stand-alone LTCi policies only; it cannot be used to exchange from an annuity to a life insurance policy with an LTC rider
- This technique allows taxable annuity gains to be received as a tax-free LTC benefit if the owner qualifies under the LTCi policy to receive benefits
- This must be a tax-qualifying LTCi policy under IRC 7702B
- Partial exchanges are prorated, which means the exchanged amount contains the same ratio of gain to cost basis as the source contract

Steps

- Purchase a nonqualified annuity now, not only to take advantage of the annuity's benefits but also to build the annuity cash value for potentially tax-advantaged future LTCi funding
  - This technique works only with exchanges from a nonqualified annuity, not from an IRA or qualified plan
  - The LTCi provider must be willing to accept 1035 exchanges; not all do
  - Usually undertake partial exchanges from a deferred annuity each year to pay LTCi premiums
  - Annuity owners should be aware of any surrender charges before undertaking 1035 exchanges to fund LTCi

How it works



Target audience: *1) clients who may have a need to fund future LTCi premiums and want to do it in a potentially tax-advantaged way; 2) clients who have deferred annuities with deferred gains and are looking to fund LTCi premiums now*

Marketing resources

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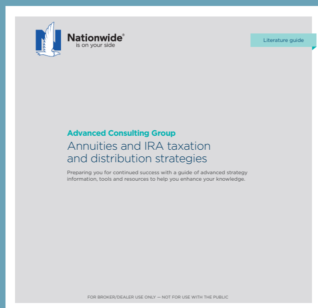
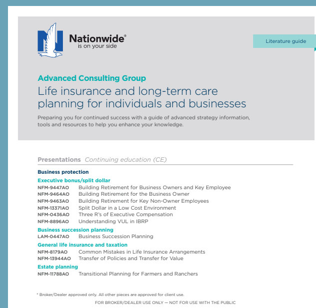


Annuities and IRA taxation and distribution strategies

NFM-13791AO



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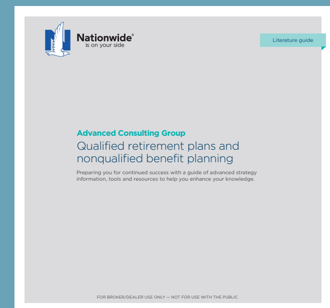

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