5 Savvy Ways an Annuity Can Help in Building and Transferring Wealth

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We think of annuities as providing protected lifetime income for retirees, but they can be put to other, not-so-obvious uses as well, including for building wealth and passing it on to heirs.

Typically, annuities are purchased to act as some sort of guarantee for retirees. Stated differently, when we think tax "annuities," we think tax deferral along with "guaranteed income" or "death benefit." However, there are more creative uses for annuities, particularly now during a time where taxes are rising. In short, annuities are not only useful in this lifetime, but can also be used to build wealth or transfer wealth to heirs. Specifically, an annuity can generate tax savings now and also help to reduce tax exposure for beneficiaries in the future—when structured properly.

We provide five strategies below where an annuity can make sense when building or transferring wealth.

1. Obtaining a lower tax rate

For some clients, their capital gains tax rate may be higher than their ordinary income tax rate so annuities can make sense at certain income levels (tax arbitrage).

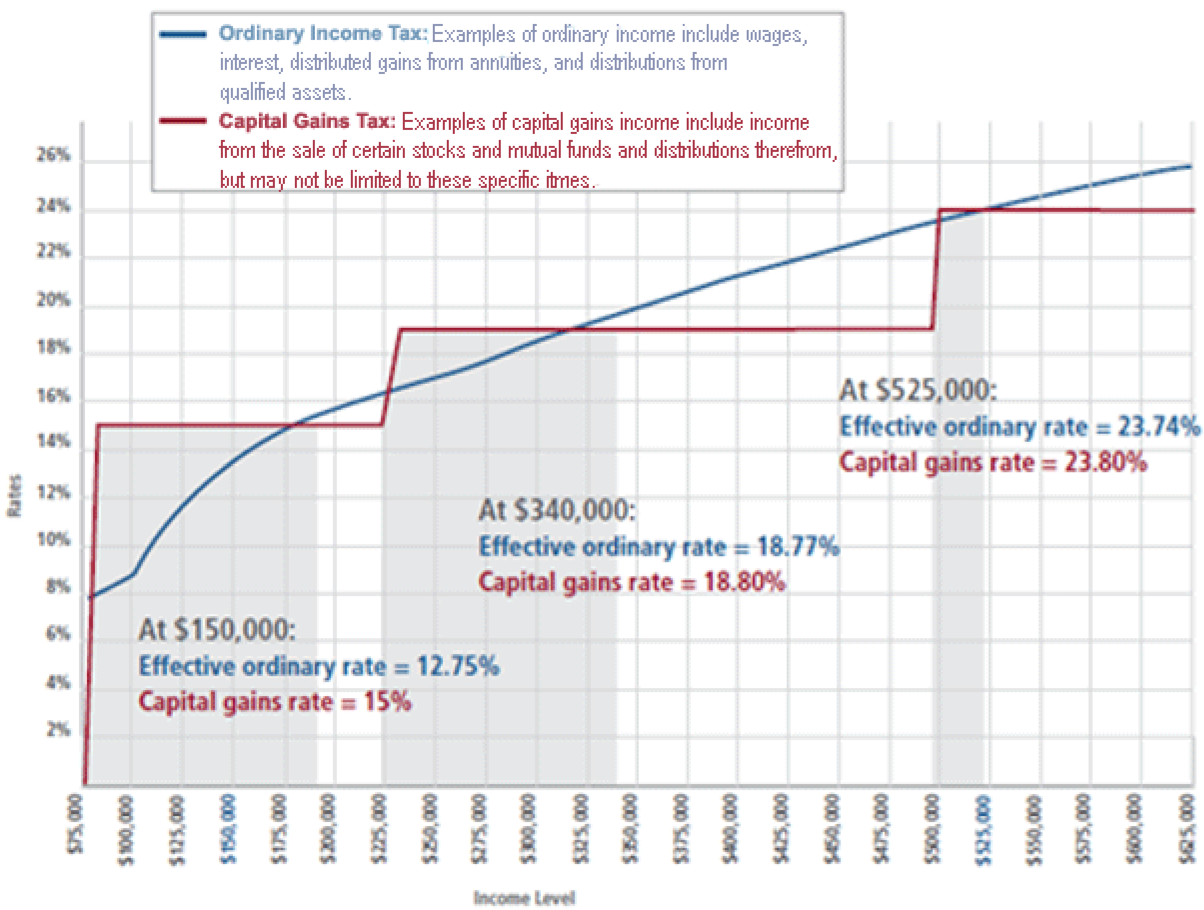
As we know, there are many times when paying the capital gains tax over ordinary income tax is the clear winner due to the currently preferred capital gains tax rates. However, there are situations where the ordinary income tax rate can be lower than their capital gains tax rate.

For example, at an income level of $150,000 for married filing jointly (MFJ), the effective ordinary income tax rate is 12.75% while the capital gains tax rate is 15.00%. Looking at Figure 1 below, you see from $80,000 in income all the way up to about $175,000 of income, an annuity would make sense as ordinary income is taxed less than capital gains. Also, from about $250,000 to $340,000 of income, the ordinary income tax rate is either lower or similar to the capital gains rate.

At $340,000 of income for MFJ, the effective ordinary income tax rate is 18.77% while the capital gains tax rate is 18.80%, effectively doing away with the tax arbitrage. Lastly, with income of $525,000 for those married filing jointly, the effective ordinary income tax rate is 23.74% while the capital gains tax rate is 23.80%, thus providing similar taxation.

These surprising numbers are a result mainly of two things: lowered income tax rates from the TCJA and the fact that we have a marginal tax rate system (and not cliff rates). And the point being is that although the capital gains rate is preferenced (at least for now), it is not the better rate at *all* income levels and therefore it needs to be reviewed as part of the recommendations when considering an annuity.

Figure 1: Income vs. Capital Gains Tax Rates



Source: Jackson National Life Insurance Company

Therefore, an annuity can make more sense at many income levels than a taxable account as income withdrawn from all types of deferred annuities is taxed as “ordinary income,” not long-term capital gain income. This tax treatment applies to fixed-rate, fixed-indexed, variable and income annuities.

2. Avoiding forced distributions and more

Place the annuity into a trust (Spousal Lifetime Access Trust or "SLAT") to avoid forced distributions and trust taxation, and to allow for tax deferral, and tax efficient trading.

When an annuity is placed in a trust, the trust can be eligible for tax deferral under IRC Section 72(u), and during the accumulation phase, the annuity can offer asset growth with tax deferral, control when income is distributed and recognized, and simplified management and reporting.

Specifically, Spousal Lifetime Access Trusts (SLATs) provide a way for a married individual to use their lifetime gift and estate tax exemption amount to benefit their spouse and next generation. Each spouse can set up a SLAT for the benefit of the other spouse, thereby using up to $11.7 million in lifetime gift and estate tax exemptions per individual.

Any gift of assets to the SLAT removes the assets from the grantor's taxable estate and the beneficiary spouse's taxable estate if structured properly. However, the grantor would have limited access to the trust assets (as this is a requirement to be able to use the lifetime and estate tax exemption). Once the second spouse dies, if the assets are not placed in an annuity, then the SLAT would typically be subject to the trust tax rates, which are very high as described below.

With a trust, if assets are maintained in income-generating investments, earnings are subject to more compressed trust tax brackets compared to individual tax rates. A $1 million trust would only need to generate approximately 1.30% ($12,951) in retained earnings to be subject to the top trust tax rate of 37%. Then add another 3.8% for Medicare tax and you get a total trust tax rate of 40.8% (plus potential state taxes) on annual income of less than $13,000.

As an example, assume we have $1,000,000 and an annual growth rate of 8%. If we put the monies in a taxable account and the trust retains the income it earns each year, most of the income will be exposed to the top federal trust tax rate of 40.8%.

	Place Money into a Taxable Account	Place Money into a Nonqualified Tax-Deferred Annuity
Year 1	$1,000,000	$1,000,000
Year 5	$1,212,691	$1,338,226
Year 10	$1,468,742	$1,790,848

Source: Jackson National Life Ins. Co.

However, if we were to use the monies to purchase an annuity, the earnings would grow tax deferred and would be taxed as ordinary income once withdrawn or distributed.

Therefore, the annuity can potentially generate much more value than the taxable account would (see chart at right).

However, with an annuity, those punitive trust rates described above do not apply. In addition to the tax deferral and accumulation benefits, annuities also provide two key wealth transfer options. The trustee has two titling options to determine how the money from the trust-owned annuity will be distributed to the children once the surviving spouse passes away.

Option 1: Standard titling is optimal for providing liquidity

If liquidity is needed, standard titling would allow for the annuity death benefit to be triggered once the surviving spouse passes and the trust would dispense the death benefit according to the trust terms. All monies distributed to the beneficiaries (or trust, if retained) would be taxed as ordinary income.

Option 2: 'Pass-in-kind' titling is optimal for extending the tax-deferral benefit

If the goal is to maximize the period of tax deferral, "pass-in-kind" titling would allow the annuity to be retitled from the trust as owner, to the annuitant (child) as owner and does not trigger a taxable event. If option 2 is chosen and the annuity is passed to the child, upon that child's death, the heirs could now take a lump sum payment if the cash is needed immediately or choose to stretch distributions over their life expectancy (based on IRS Table 1, Publication 590-B).

By stretching distributions, the remaining value in the annuity will continue to grow and the total lifetime distributions would likely be significantly greater than the lump sum. It is also important to note that with this strategy, the beneficiary would be taking distributions each year, which would affect taxable income (as distributions are taxed as ordinary income). Therefore, it may make sense to do some additional tax planning to project how the additional income could affect the annual tax liability.

3. Stretching annuities

Annuities allow the option for a "stretch," so that when an original annuity owner dies, you can 1035 the annuity into another annuity and stretch the distributions after death.

"Nonqualified stretch" is a death benefit distribution option that allows the beneficiary of an annuity to "stretch" the death benefit via systematic withdrawals over a period not to exceed the beneficiary's life expectancy. These annuity payments satisfy IRS distribution requirements while offering flexibility and control over investable assets.

The ability to stretch distributions and income has become more valuable than ever due to the passing of the SECURE Act that now requires non-spouse beneficiaries to draw down traditional IRA's within 10 years and can no longer "stretch" out required minimum distributions (RMDs) over their lifetime.

In 2013, the IRS issued Private Letter Ruling (PLR) 201330016 clarifying the opportunity for beneficiaries to 1035 a death benefit to a new carrier of the beneficiary's choice. This allows the beneficiary of an annuity death benefit to transfer the monies to a new annuity (even to a different carrier) to "stretch" distributions over his or her lifetime so the monies can stay invested according to personal financial needs and goals while still deferring taxes.

4. Providing for long-term care

To help your client cover long-term care expenses, consider annuity products with a long-term care rider.

An annuity with a long-term care rider has a portion of funds set aside for the annuitant's care and heirs would get any unused money. Long-term care payments are tax-free, including any gains from the annuity.

In addition, underwriting for annuities with long-term care coverage tends to be less strict than underwriting for traditional long-term care policies. For insurance, those with certain health issues may not be able to qualify for traditional long-term care insurance, but they may be able to qualify for this type of annuity. However, if in good health, a traditional long-care policy may be the better option as it will typically offer higher benefits than the annuity with a long-term care rider.

5. Protecting assets from Medicaid spend-down

Buy a Medicaid-compliant annuity, which pays your client and spouse income for life and does not count toward the Medicaid asset test, allowing for faster qualification.

If your client requires care in a nursing home or assisted living facility, they'll need to deplete most of their assets to qualify for Medicaid, but that can leave their spouse with little to live on. Although requirements vary by state, generally nearly all assets need to be spent down to less than $2,000 with exceptions for some things like a personal residence and one vehicle.

Your client can potentially keep more of their savings if they buy a Medicaid-compliant annuity, which pays the client and spouse income for life and does not count toward the Medicaid asset test, letting them qualify faster. For the annuity to be Medicaid-compliant, the payments must start immediately, with the state named as the beneficiary once the client and spouse pass. The state would then get any remaining payments after passing. Of course, one challenge with this approach is that the client is on Medicaid and so some of their options may be limited when looking for care in certain facilities.

In conclusion

As tax law changes, doubtless the benefits of annuities will grow. When looking for a financial tool that can help to build wealth or transfer wealth to heirs efficiently, consider an annuity. Annuity products are no longer limited to only providing income for a couple but have become a multipurpose tool for saving taxes and passing on wealth.

If you have any questions or concerns, I would love the opportunity to meet with you to discuss your retirement and investment goals.

Kind Regards,

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