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White paper

# Trust-owned annuity planning

## A multi-layered story


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In this paper we'll examine the planning strategies of tax-deferral, in-kind transfer and nonqualified stretch which a family can use with annuities to build multi-generational family wealth.

We'll also look at how annuity products have the potential to further enhance these planning strategies through investment diversification, death benefit options and/or living benefits.

Let's start with a scenario:

Assume there is $1 million inside Sam Miller's irrevocable Credit Shelter Trust (CST). Sam died some years ago and his CST was funded at that time. This CST may pay income to Sam's surviving spouse, Jane (74), and at Jane's death trust assets may be distributed to Sam and Jane's children, Lucy (53) and Peter (50). Additionally, Peter has two children Sarah (25) and William (23) and Lucy has one son, Trevor (30). Jane wants her children and/or grandchildren to receive the bulk of this wealth and does not need income from this trust.

Working with their advisors, the family develops a strategy that will utilize the planning techniques of tax-deferral, in-kind transfer and nonqualified stretch, and what we'll see at the end of this plan is how a $1 million investment in annuities can yield $12,741,812 in distributions over the lifetimes of their grandchildren.

## Phase one — Annuity purchase

At this point, the trustee of the trust purchases two $500,000 annuities, where the trust is the owner, Peter and Lucy are the annuitants respectively, and the trust is the beneficiary on each policy. Peter and Lucy are named the annuitants on their respective policies because at some point in the future the policies will be distributed to them. This planning technique is called an in-kind distribution of trust property and we'll look at the specifics of this technique in phase two.

In phase one, purchasing the annuities in the trust provides several benefits for the family's wealth building plan beyond the set-up for phase two of the plan, those phase one benefits include tax deferral, income control and ease of administration. Let's look at each of these benefits separately.

**Tax deferral**

In 2018, the highest income tax rate for trusts is 37%. The income threshold for reaching the highest rate is $12,501. In comparison, for a single individual, the 37% rate is reached at $500,001 of income, a dramatic difference in the amount of income that could be subject to the highest income tax rate for income generated by trust assets versus individual taxation. Finally, the 3.8% Medicare investment earnings surtax may apply to trust income taxed at the 37% rate — together this creates a potential ordinary income top tax rate of 40.8% for trust ordinary income and could be a reason to consider a tax deferred annuity in which to invest trust assets to avoid these income tax rates and thus accumulate in a tax-deferred compound manner.

So, how are annuities owned by trusts able to receive tax deferral? If the trust can be considered as acting as the agent of a natural person, then an annuity owned by the trust may receive income tax deferral. The standard for determining if a trust is acting on behalf of people

is usually whether or not the beneficiaries of the trust are people. Ultimately, this determination is made by the trustee in conjunction with their tax advisors and indicated to the annuity company on an administrative form.

In the Miller's plan, tax deferral is likely to be an important element of the plan because avoiding ongoing income taxation creates the possibility of building more wealth. So, let's do a comparison of the accumulated amount in a taxable investment account versus the accumulated amount in the tax deferred annuities over a 10-year timeframe to see if tax deferral would be beneficial for the Millers.

Assume the $1 million trust investment was put into a yearly taxable investment, which grows at a 6% net-rate-of-return, with an effective tax rate for the trust of 35%[1] and distributions are taken from the investment to pay taxes. Further assume that trust tax rates and income brackets do not change over the course of the example and that the hypothetical effective tax rate takes into account the progressive nature of the income tax brackets for the first $12,501 of trust income. For comparison purposes, assume they invest the same $1 million in tax-deferred annuities at a 6% net-rate-of return and no distributions are taken from the annuity.

The result is that after 10 years, the accumulated balance of the taxable investment is $1,447,133, whereas the balance of the tax-deferred trust owned annuities would be $1,790,848 — a difference of $343,715 more in accumulation with the tax-deferred annuities.

**Income control**
CST's like the Millers' may pay income to a surviving spouse until the surviving spouse's death and then distribute the assets of the trust to children. However, some trusts are obligated to pay out income to the surviving spouse to the extent it's earned and given that most trust monies are invested in fixed income producing assets (money markets, bonds, CD's, etc.) to preserve principal, there may be significant income that has to be distributed to the surviving spouse even if they don't want or need it. An annuity can mitigate this problem because in most states, the internal build up of an annuity is not considered income; thus, it does not need to be distributed to the surviving spouse and because that undistributed money is invested in a tax deferred vehicle it has the potential to accumulate for the children.

**Ease of administration**
Using a tax deferred annuity can ease the trustee's ongoing administrative burden associated with the trust. Tax reporting will only occur when distributions are taken from the annuity and the annuities investment features, for example the indexes in a fixed indexed deferred annuity or variable subaccounts in a variable deferred annuity, can provide investment diversification.

## Phase two — In-kind transfer to children

After the 10 years of accumulation we saw in phase one, Jane then passes away. Under our previous assumptions of a 6% net growth rate, the value of each annuity is $895,424 (combined value of both annuities is $1,790,848).

At this point, the trust may distribute trust property to the trust beneficiaries, which means that the ownership of the two trust owned annuities will be changed from the trust to Peter and Lucy respectively who are also the annuitants on the policies. This in-kind distribution to Peter and Lucy will not accelerate the tax on the inside build-up, as the Internal Revenue Service concluded in Private Letter Ruling (PLR) 199905015, provided that the trust beneficiary taking over ownership of the policy is also the annuitant on the policy. Please be aware that this strategy is based on a PLR and it is not precedent setting authority. Legal and tax advisor sign-off is important to ensure its proper implementation.

Now that these policies are owned by Peter and Lucy respectively, they may change the beneficiaries to their own children, take distributions, or continue tax deferral if no distributions are taken. If distributions are taken, then the owner of the respective policy must include any gains received as taxable income.

Assume that neither Peter nor Lucy take distributions from their policies for the remainder of their lives — here 15 years. If these annuities continue to grow on a tax deferred compound basis at a 6% net-rate-of-return, the value of each annuity after 15 years is $2,274,692. In essence, over the first 25 years of this plan with the power of tax deferral, we have turned the total initial $1 million investment in two annuity contracts into $4,549,383 of pre-tax combined contract value.

# Phase three — Nonqualified annuity stretch by beneficiaries

At the time of Peter and Lucy's deaths, Sarah (50) and William (48) are named 50% beneficiaries on Peter's policy and Trevor (55) is the sole beneficiary of Lucy's policy.

All three beneficiaries make the election to stretch, meaning they are going to use their own life expectancies, as established by the IRS Single Life Table, to take out their required minimum distributions (hereafter referred to as beneficial RMDs) from this nonqualified annuity that they are inheriting. The balance of the beneficial annuity funds will then stay invested and potentially grow tax deferred in the beneficial annuity account.

Thus, Sarah is stretching $1,137,346, William is stretching $1,137,346 and Trevor is stretching $2,274,692. Sarah's life expectancy is 33.3 years, William's is 35.1 and Trevor's is 28.7. Over these respective life expectancies, assuming they only withdraw the required minimum amount out every year, the collective total of distributions from these inherited annuities to the beneficiaries is $12,741,812.

Through this whole scenario, what we have done is used sixty years of annuity tax deferral and the inkind distribution planning technique to build significant intergenerational wealth for this family.

**Annuity products and features that may enhance a family's plan**

The planning scenario we described above can be further enhanced by the features of the annuity products that are chosen to be part of the plan.

For instance, an annuity product that focuses on accumulation combined with death benefit protection may be attractive if the family is looking to grow assets and do it in a protected way. The family may also choose an annuity product that contains a living benefit rider which would allow the trust beneficiaries to have a potential lifetime cash flow guarantee that they control, when the policy is distributed to them by the trust.

**Next steps**

In this example, you've seen how using trust owned annuities in a family wealth building plan can provide the opportunity to create significant multi-generational family wealth through tax deferral. If you are interested in potentially using this idea in your practice, consider looking for irrevocable trust accounts where the grantors and/or surviving spouses have a desire to leave behind something more then just a lump sum of cash, maybe something like an annuity.

To talk through the details of a specific case, call your Nationwide wholesaler or Nationwide's Advanced Consulting Group at 800-321-6064, extension 677-6500.

[1] Note that if a blended tax rate is assumed for the investments held outside the annuity (say 20%), the difference between the account balances would be less, although may still be favorable for the annuity.

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NFM-12987AO.3 (02/18)