TAX-DEFERRED ANNUITIES—THREE TIPS AND A TRAP

Nonqualified annuities have several unique benefits. Some might be on your radar. Others, not so much. Let's consider three strategies where a nonqualified annuity might surprise you. And there's one trap to avoid!

Nonqualified annuities, that is, those falling under IRC Section72, have several features that can translate to potentially attractive benefits. Below are some tips on how annuities may help some clients—along with a trap that bears noting.

Create Tax-Advantaged Cash Flow

Many retiree clients will use some of their retirement capital to support their lifestyles. Nonqualified tax-deferred annuities offer the option of guaranteed lifetime income. While distributions from deferred annuities are generally last in, first out (LIFO), annuitization can create tax-advantaged cash flow. If all, or a portion, of a tax-deferred annuity is annuitized following the IRS rules, the resulting stream of payments receives favorable exclusion-ratio tax treatment. Each payment is a combination of returned premium and income (credited interest for fixed; gains for variable). As an example, the retiree might receive a monthly payment of $1,000, but only $150 would be considered taxable income. This can help retirees manage taxes as well as various income thresholds, such as for Medicare and the net investment income tax (NIIT).

Repurpose Cash Value Life Insurance

Even with the best planning, sometimes a life insurance policy is no longer needed or has a premium the client is unwilling to support. The contract can be surrendered, but there may be either taxable gains or a nondeductible loss.

Is there an option other than surrendering the policy? Yes, use a 1035 exchange to transfer the cash value to a tax-deferred annuity. If the basis in the life insurance policy is more than the cash value, then the growth up to the basis is not considered a gain. For example, if a life insurance policy has $30,000 of cash value, but $50,000 of basis, then the annuity will not have gains until the value passes $50,000. Do be careful: this transaction only goes one way. The IRS does not permit an annuity to transfer to life insurance.

Leave a Legacy

Beneficiaries of nonqualified tax-deferred annuities still have the option of stretching the contracts over their life expectancy. While the Setting Every Community Up for Retirement Enhancement Act (SECURE Act) limited this option for qualified accounts, such as IRAs, it remains in place for nonqualified annuities. This means the beneficiary can elect to (or via a predetermined payout option, be required to) distribute the contract over his or her life expectancies. This can help manage the tax bill on any gains. (There also are some additional benefits available for a fee that can help with taxes.)

Watch for a Trap!

The stretch option is available only if all the named beneficiaries are natural persons. If a trust is the beneficiary, in most cases the ONLY distribution options are lump sum or five years - even if all the trust beneficiaries are natural persons. This can even include a spouse as a beneficiary! Even when a marital trust is used, careful planning is required to protect a spouse from this outcome.[1]

The features of annuities can translate into great strategies for some clients. An annuity can create tax-favored cash flow, help repurpose a life insurance policy, and leave a tax-manageable legacy. Keep these strategies in mind when planning.

[1] IRS Response to PLR-142960-02

Additional Resources and Links

Blogs about Tax Planning

Beneficiary Planning

Understanding Medicare Options

Annuities: Certain proceeds of endowment and life insurance contracts

For more information about retirement planning, please contact our Retirement Strategies Group at RSG@PacificLife.com or (800) 722-2333, ext. 3939.
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