PACIFIC LIFE | ADVISORY

Legacy Planning Using Advisory Annuities

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About This White Paper

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As of January 1, 2026, the current lifetime estate and gift tax exemption may be cut in half (adjusted for inflation). After this date, estate-plan beneficiaries of your high-net-worth (HNW) and ultra-high-net-worth (UNHW) clients could see their intended inheritances significantly reduced unless new tax-efficient plans are made before the fast-approaching deadline. This paper shows how annuities can effectively help your clients leave the meaningful legacies they intend and even extend the benefits of tax deferral to their loved ones and favorite charities.

About the Author

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The record expansion of the high-net-worth (HNW) and ultra-high-net-worth (UHNW) investor base resumed in 2023 following the downturn that occurred in 2022.[1] However, there is now a perfect storm of aging and soon-to-sunset favorable regulations that has made estate planning top of mind for many HNW/UHNW clients. They're relying on their financial advisors to help them efficiently pass assets to their beneficiaries as the race against their mortality clocks and sunsetting tax regulations enter a final sprint.

Nonqualified Advisory Annuities—A Viable Strategy for Legacy Planning

Not only do annuities bypass the probate process, but they allow natural beneficiaries to control taxable distributions over their life expectancies, may be used to achieve tax deferral within various trusts, and can play a role in certain charitable-giving strategies. Fiduciary financial professionals who understand the legacy-planning uses for advisory annuities can distinguish themselves from competing firms who do not provide insurance solutions to their high-net-worth clients.

The Perfect Storm

According to Cerulli and Associates, estate planning and tax planning are now the fastest growing service areas of HNW practices, and there's a good reason. The number of HNW households grew from 677,000 in 2011 to 2,350,000 by the end of 2022. It is estimated that more than $84 trillion in assets will be transferred by 2045.[2] And $31 trillion of those assets were held by high-net-worth and ultra-high-net-worth households at the end of 2022.[3] Baby boomers started hitting "Peak 65" in 2024 with more than 4.1 million turning age 65 every year from 2024–2027.[4] Baby boomers held over half of the wealth in the United States at the end through the first quarter of 2024.[5]

The Tax Cuts and Jobs Act (TCJA) of 2017 that is scheduled to sunset at the end of 2025 presents a problem that could greatly reduce the inheritances of the beneficiaries of this great wealth transfer. The sunset will reduce the current lifetime estate and gift tax exemption from $13.61 million per person and $27.22 million for a married couple, back down to approximately $7 million per person and $14 million for couples.[3]

Fiduciary financial professionals who understand the legacy-planning uses for advisory annuities can distinguish themselves from competing firms who do not provide insurance solutions to their high-net-worth clients.

[1]Kaminer, Michael. "'Wealth Creation Is Back'—U.S. Poised for Huge Growth in Ultra-Rich Population." Barron's. February 28, 2024.

[2]Cerulli Associates. "Cerulli Anticipates $84 Trillion in Wealth Transfers Through 2045." Cerulli.com. January 20, 2022.

[3]Horton, Chayce, et al. "The Cerulli Report: U.S. High-Net-Worth and Ultra-High-Net-Worth Markets 2023—The Evolution of Service Delivery." Cerulli Associates. 2023.

[4]Konish, Lorie. "As baby boomers hit 'peak 65' this year, what the retirement age should be is up for debate." CNBC. February 8, 2024.

[5]Statista Research Department. "Wealth distribution in the United States in the first quarter of 2024, by generation." Statista. August 23, 2024.

Additionally, the top individual income-tax bracket of 39.6% will be reinstated. The Federal individual income-tax rates are 10%, 12%, 22%, 24%, 32%, 35%, and 37% under the TCJA. However, these rates will return to their pre-TCJA amounts of 10%, 15%, 25%, 28%, 33%, 35%, and 39.6% on January 1, 2026.[1] The income brackets to which those rates apply also will be different and will be adjusted for inflation annually.

Below are tables of the current federal amounts for estates and trusts, in addition to a simplified example of how a married couple with a $20 million estate might be taxed at death in 2024 compared to 2026 without the increased exemption amounts of the TCJA.[2] To illustrate how this change could affect clients' estate-tax planning:

2024 Federal Amounts for Estates and Trusts			
Minimum	**Maximum**	**Tax on Minimum**	**Rate on Excess**
$0	$3,100	$0	10%
$3,101	$11,150	$310	24%
$11,151	$15,200	$2,242	35%
$15,201	–	$3,660	37%

Potential Estate Taxes in 2024		Potential Estate Taxes in 2026	
Total Estate (Married Couple)	$20 million	Total Estate (Married Couple)	$20 million
2024 Estate Tax Exemption	$13.61 million per spouse = $27.22 million	2026 Estate Tax Exemption	$7 million per spouse = $14 million
Previous Taxable Gifts	$100,000 per spouse = $200,000	Previous Taxable Gifts	$100,000 per spouse = $200,000
Remaining Estate Tax and Gift Exemption	$27.02 million	Remaining Estate Tax and Gift Exemption	$13.8 million
Total Estate minus Exemption	$20 million–$27.02 million	Total Estate minus Exemption	$20 million–$13.8 million
Estate Tax Due	$0	Estate Tax Due	$6.2 million

The mix of so many clients entering the later stages of life and estate taxes going up very soon has the financial advisors, accountants, and lawyers of HNW and UHNW clients working feverishly to make sure wealth-transfer strategies are already in motion. Many heirs do not keep the same financial advisor as their parents had after they receive their inheritances for a number of reasons, which could present an opportunity to those financial advisors as wealth transfers are set to exceed $1 trillion annually.[1] Nonqualified advisory annuities, using the nonqualified stretch provision, may be a viable strategy for asset transfers left in the estate or placed outside the estate (in certain irrevocable trusts), which can lead to heirs keeping their money in a tax-deferred annuity and under the management of the same financial professional.

[1]PNC Insights. "2026 Tax Law Changes: Prepare for TCJA Provisions to Sunset." PNC Financial Services Group. February 5, 2024.

[2]Hecht, Devin, J.D., LL.M. "Estate and Gift Tax—Estate Planning Now and for the 2026 'Double Exemption' Sunset." EideBailly. Accessed June 12, 2024.

Annuities Have Evolved and Are Available to Registered Investment Advisors

Annuities have come a long way. And modern advisory annuities are now designed for the way fiduciaries do business. It took some time, but a good number of annuity carriers can now offer advisory annuities that do not pay commissions, offer institutionally priced investment options, and allow fiduciaries to bill their advisory fees directly on the annuity without creating taxable events[1] or reducing the clients' benefits. Fiduciary financial professionals now have a full suite of advisory fixed, fixed indexed, registered index-linked, and variable annuities to put to work for their clients. Furthermore, these annuities can be accessed through Outsourced Insurance Desks (OIDs) or often, directly from the carriers themselves (both of which are properly FINRA and Life Insurance licensed) without the requirement of FINRA and Life Insurance licenses. Finally, advisory annuities can now be integrated into popular advisory wealth-management digital platforms. These platforms allow fiduciary financial professionals to seamlessly integrate annuities into their clients' accounts.

Financial professionals who are unfamiliar with annuities are often surprised to find that annuities can be used for legacy planning. In fact, there is an entire section of the IRC 72(s) tax code that covers the rules determining how annuities are to be passed to beneficiaries. Annuities are effectively insurance policies and, therefore, are a beneficiary-designation asset. This means that if the estate is not the beneficiary, the beneficiaries of annuities will receive the asset without the hassle of delays and costs of the complicated probate process.

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It's often pointed out that an annuity beneficiary does not receive the one-time step-up in cost basis once the annuity is passed to him or her. This is true, because the owner received the benefit of tax deferral during his or her lifetime. The step-up in basis is not available for annuities that is used to achieve tax parity with taxable investments during the owner's lifetime. Instead, they are treated as income in respect of a decedent, which is untaxed income that the deceased person had earned or had the right to receive during his or her lifetime. Thus, beneficiaries must pay the taxes that the owners were allowed to defer and must bring the taxation of that asset in line with other assets the owners paid taxes on during their lifetimes.

Legacy-Planning Use Cases for Nonqualified Advisory Annuities

1035 Exchanges for Cash Value Life Insurance or Clients' Older Annuities

Because annuities bypass the probate process and have no contribution limits, a nonqualified annuity could be a strategic legacy-funding option for HNW/UHNW clients who can't qualify for life insurance. A sometimes-overlooked legacy-planning option for HNW/UHNW clients is a tax-free exchange of an existing life insurance policy's cash value into a nonqualified annuity. A client may have any number of reasons why the current policy no longer fits his or her needs. These can include not wanting to pay increasing premiums or wanting to avoid potential policy lapses that would eventually deplete the policy's cash value. After careful examination of the clients' current situation, executing a 1035 exchange into a nonqualified annuity has the potential to preserve and grow those assets.

Additionally, if a client has existing annuities and determines they no longer support his or her goals, a 1035 exchange into a modern advisory annuity also is a potential option for preserving a legacy for beneficiaries.

[1]PLR 201946001 (November 15, 2019)

Nonqualified-Stretch and Post-Death 1035 Exchanges

Tax deferral allows tax-inefficient assets to grow without tax drag and without required minimum distributions (RMDs) for the original owners of nonqualified annuities. Beneficiaries of nonqualified annuities have flexible options for receiving their inheritances. Natural (persons) beneficiaries have the option to take their inheritances in a lump sum, liquidate over a period of 5 years from the original owner's death, or as an annual RMD of the account value over their life expectancies. The last option is one that many financial professionals thought the Setting Every Community Up for Retirement Enhancement (SECURE) Act eliminated. While the SECURE Act did change qualified RMDs (qualified stretch) for designated beneficiaries, nonqualified stretch provisions may still be an option for natural beneficiaries. This option allows for assets that are not distributed to remain invested and provides some control over taxable income from year to year without having to realize the larger taxable event of a lump-sum distribution.

What about clients who have already passed away owning nonqualified annuities? Are the beneficiaries stuck with that annuity and required to stay at the current annuity carrier? Fortunately, no. Beneficiaries of a nonqualified annuity who have elected to receive nonqualified stretch payments, have the option of a post-death 1035 exchange. Beneficiaries of these annuities can transfer them to a new annuity carrier, exchange the previous annuity for a modern advisory annuity, and execute the nonqualified stretch provision.[1] It must be noted that the nonqualified stretch provision[1] must be executed within 365 days from the date of death of the original owner.

Trust-Owned Annuities

Annuities owned within irrevocable trusts are another misunderstood or not widely known legacy-planning strategy where annuities can offer unique strategies. Most irrevocable trusts are subject to highly compressed tax brackets where retained income can be taxed at the highest income-tax rates—in addition to the 3.8% Net Investment Income Tax—very quickly.

An annuity contract will retain tax deferral when owned by a trust if that trust is "an agent for a natural person." These types of trusts include credit-shelter trusts, dynasty trusts, generation-skipping trusts, spousal lifetime-access trusts, and special-needs trusts. The IRS has issued a series of private letter rulings over the years that allow for tax-favorable planning strategies, provided that the grantor (for a grantor trust), or trust beneficiaries (for a non-grantor trust) are natural people using annuities.[2] An advisory annuity can be used as a strategy to balance the dual fiduciary duty of current-income beneficiaries and remainder beneficiaries by allowing for tax-deferred growth within these types of trusts.

Trust-owned annuities can even be set up for strategies that allow for tax planning at different levels. Accumulation and income control can be planned for one generation or used for multigenerational wealth transfer via "Pass-in-Kind" titling, which has the potential to extend tax deferral for multiple generations.[3]

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[1]IRS Private Letter Ruling (PLR) #201330016 allows tax-free transfers of the death benefit on tax deferred annuities so long as the transfer is initiated and completed within one year of the original owner's death.

[2]IRS Private Letter Ruling (PLR) 202031008.

[3]IRS Private Letter Ruling (PLR) #199905015 gives trustees the ability to retitle an annuity from trust ownership to a remainder beneficiary without creating a taxable event or any distribution requirements.

Charitable Planning

Charitable giving is now one of the most important priorities of HNW and UHNW clients.[1] Nonqualified advisory annuities also can be used for charitable-giving strategies. As stated previously, annuities bypass the probate process and transfer directly to the named beneficiary. A HNW client who wants to control the assets during his or her lifetime could name a charity as the beneficiary of the nonqualified annuity. The estate then receives a charitable deduction after the client passes away.

Additionally, there are potential use cases for nonqualified annuities within various types of charitable trusts.[2] For example, the IRS permits the use of variable annuities within charitable remainder unitrusts with a net-income limitation and a make-up provision as a way to hold and reinvest funds until the beneficiary desires a distribution. When establishing and administering a charitable remainder trust, it is important to work closely with tax and financial professionals who are knowledgeable about charitable-planning rules.

Conclusion

If you're a fiduciary financial professional, and you've never used an annuity for legacy planning, your HNW/UHNW clients and their beneficiaries may be missing an important opportunity. I encourage you to take a look at modern advisory annuities and see how they can play a sophisticated, tax-efficient role in your clients' estate plans. These plans take time, so act now to ensure your clients are prepared for the upcoming sunsetting of favorable estate-tax laws.

> *Your HNW/UHNW clients and their beneficiaries may be missing an important opportunity.*

[1]Horton, Chayce, et al. "The Cerulli Report: U.S. High-Net-Worth and Ultra-High-Net-Worth Markets 2023—The Evolution of Service Delivery." Cerulli Associates. 2023.

[2]IRC section 664 charitable remainder trusts (CRT) are tax exempt, so the tax deferral of annuities provides no tax benefit.

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Under current law, a nonqualified annuity that is owned by an individual is generally entitled to tax deferral. IRAs and qualified plans—such as 401(k)s and 403(b)s—are already tax-deferred. Therefore, a deferred annuity should be used only to fund an IRA or qualified plan to benefit from the annuity's features other than tax deferral. These include lifetime income, death benefit options, and the ability to transfer among investment options without incurring additional charges.

Variable annuities are long-term contracts designed for retirement. Annuities withdrawals and other distributions of taxable amounts, including death benefit payouts, will be subject to ordinary income tax. For nonqualified contracts, an additional 3.8% federal tax may apply on net investment income. If withdrawals and other distributions are taken prior to age 59½, an additional 10% federal income tax may apply. Withdrawals will reduce the contract value and the value of the death benefits, and also may reduce the value of any optional benefits.

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