ADVISORY

The Many Uses of Advisory Annuities for Fiduciary Financial Professionals

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About This White Paper

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Fiduciary financial professionals in the registered investment advisor (RIA) and trust company spaces have been resistant to using annuities because they have traditionally not seen utility in them. However, today's modern annuities are sophisticated strategies that can address the core financial-planning areas of retirement: income, tax, and legacy planning. This paper shows ways that advisory annuities can be useful to fiduciary financial professionals within these important planning areas and also explores the many reasons annuities can help their clients.

About the Author

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Pacific Life has committed to building advisory annuities that help fiduciary financial professionals provide strategies that meet a variety of client needs. Pacific Life's advisory annuities offer cost-conscious contract charges and allow financial professionals to withdraw their advisory fees directly from a client's annuity tax-free[1] and without impacting the benefit. These annuities also are competitively priced and transfer several types of risks to an industry-leading insurance carrier. Pacific Life Advisory is happy to provide fiduciary financial professionals with case designs and consult on the many planning uses for advisory annuities.

Fiduciary financial professionals can now access Pacific Life's fee-only annuities directly through Pacific Life's Advisory Solutions Desk, well-respected custodians like Charles Schwab and Pershing, or outsourced insurance desks that include DPL, The Blueprint Insurance Services, Halo, RIA Insurance Solutions, Retire One, Palladium Group, Insurance Solutions by Producer's Choice, The Pinnacle Group, Financial Distributors Group, and TruChoice Financial Group.

In addition, Pacific Life's advisory annuities are able to be integrated into popular advisory wealth-management platforms such as Black Diamond, Orion, SS&C Advent, Envestnet, Tamarac, Morningstar ByAllAccounts, and Advyzon.

[1]Private letter ruling 201946002.

Insurance products are issued by Pacific Life Insurance Company in all states except New York and in New York by Pacific Life & Annuity Company. Product availability and features may vary by state.

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In the wake of the Coronavirus pandemic, clients are more aware of their mortality and, as a result, are looking to their financial professionals to provide strategies that will help them manage longevity risk, protect their assets from unnecessary taxation, and efficiently pass those assets on to beneficiaries.[1] As a way of addressing these goals, advisory annuities are finally getting more attention and gaining acceptance within the fiduciary financial-professional community. Why? Because there is now a greater realization about how annuities can be used as part of a solution to pursue strategic outcomes and help clients reach financial goals in the core planning areas.

Many of the previous obstacles to using annuities in the business models of fiduciary financial professionals have been resolved to allow financial professionals at registered investment advisor (RIA) firms, trust companies, and family offices to deploy annuities as strategies for retirement-income planning, tax planning, asset protection, wealth management, and estate planning. This can include the ability to manage and bill on clients' accounts without creating taxable events as well as transferring some risk to the issuing insurance company.

Fiduciary financial professionals who understand the many planning uses for advisory annuities will distinguish themselves from competing firms that do not provide insurance strategies to their clients.

Annuities can be used to:

- Provide guaranteed income strategies.
- De-risk portfolios by incorporating advisory indexed annuities as a bond or fixed income complement.
- Lower taxable income for high-earning clients by relocating tax-inefficient investments into mirrored tax-deferred subaccounts.
- Defer and potentially reduce high taxes within irrevocable trusts.
- Move clients from commissionable annuities that may no longer be serving their needs (and are sometimes more expensive) into a modern, fee-friendly[2] annuity.
- Allow beneficiaries to control their inheritances through a nonqualified, life-expectancy stretch option while staying invested in the markets.

All guarantees are subject to the claims-paying ability and financial strength of the issuing insurance company and do not protect the value of the variable investment options, which are subject to market risk.

[1] Skinner,Ryan, "Annuities: Offering Protection in a COVID-Crazy World," InsuranceNewsNet.com, August 24, 2020.

[2] Refers to the ability to bill advisory fees up to 1.50% per calendar year directly on clients' assets without creating a taxable event or reducing the annuity benefit.

Retirement-Income Planning

Running out of money in retirement is a fear that many clients have. A majority even fear not having enough assets to last their lifetimes or having to compromise their lifestyles more than they fear death.[1] Sequence-of-returns risk and longevity risk are valid concerns in a world where clients are living longer, equity markets are volatile, and interest rates have been at historic lows for years. Black swan equity market events, such as what we saw at the beginning of the Coronavirus pandemic and during the financial crisis in 2008, put a spotlight on the risk of retiring and starting the distribution phase at the wrong time. Even ultra-high-income clients aren't immune to these risks. One out of 10 of those households will run out of money if retirement extends beyond 30 years.[2]

However, many investment advisor representatives (IARs) do not begin to discuss and plan retirement-income strategies for their clients until five years (and sometimes less) before a client's retirement date.[3] A short window for retirement-income planning can mean missing opportunities to deploy income strategies that allow for tax-deferred asset growth potential during accumulation, which could lessen the stress of a major life transition for their clients. At their core, many annuities are insurance products that can give clients protection through risk pooling and can reduce portfolio risk through guarantees. Annuities also can provide a cadence of steady income while still providing tax-deferred accumulation.

Tax Planning

High-net-worth and high-earning clients who have reached contribution limits in qualified accounts may have substantial assets in nonqualified taxable accounts. These accounts often are subject to annual tax reporting, which increases a client's taxable income, often in their high-income-earning years, and reduces the amount that is left in the investment account growing year by year. Nonqualified advisory annuities can be used as a solution for lowering taxable income and possibly reducing the tax drag on specific investments that are notoriously tax inefficient.

Asset location is an often-overlooked holistic approach to planning.

Fiduciary financial professionals who typically have not favored nonqualified annuities often point to the taxation of nonqualified annuities as a negative. The growth within annuities is taxed as ordinary income upon distribution, unlike preferential capital gains rates on other nonqualified investments that are held long-term. Additionally, the gains are withdrawn under last-in, first-out (LIFO) tax rules, unlike permanent life insurance that allows for principal to be withdrawn first. However, financial professionals who don't "locate" nonqualified annuities in clients' accounts may be missing some key tax benefits that nonqualified annuities can provide.

Many financial professionals are familiar with the concept of asset allocation, a fundamental investment strategy that aims to balance risk with returns for clients based on their goals, risk tolerances, and time horizons. However, asset *location* is an often-overlooked holistic approach to planning that is just as important.

[1]Shepard, Rob, and Buckler, Brad. "Will You Run Out of Money in Retirement?" Forbes.com, January 29, 2019.

[2]Coxwell, Kathleen. "What Happens if I Really Do Run Out of Money in Retirement?," NewRetirement.com, April 4, 2021.

[3]"RIAs Talk the Talk but Don't Always Walk the Walk on Annuities," InsuranceNewsNet.com, June 25, 2019.

Asset location involves putting tax-inefficient holdings such as taxable bonds, dividends, and actively managed funds into tax-sheltered accounts to reduce the impact of taxes on the portfolio. Financial professionals must remember that fund managers are concerned about achieving pretax-return benchmarks and not tax efficiency. High turnover and dividend distributions can produce undesirable tax bills for those clients at the end of each year. Even qualified dividends and long-term capital gains distributions can be problematic for high-earning clients who will be taxed at 20% federal income taxes, 3.8% net investment income tax, and potentially state taxes. This is what we call tax drag.

Morningstar analysis shows that tax drag on large-cap growth funds can reduce annual returns by almost 200%.[1] Locating tax-inefficient assets in an annuity allows the owner to time and control when gains are recognized, helping with tax efficiency. Why pay taxes today when those assets can continue to grow tax-deferred until clients are ready to take distributions? It should be noted that owners of nonqualified annuities do not have required minimum distributions while they are alive.

> *There is an entire section of the tax code that covers the rules about how annuities are to be passed to beneficiaries.*

Fees within annuities that clients already own also can drag down returns. Of course, product cost is only one consideration when deciding whether a modern advisory annuity is right for a client. Pacific Advisory Variable Annuity offers institutionally priced investment options that can help manage the effects of fee drag. Furthermore, Pacific Life has been given a private letter ruling (PLR) from the IRS that allows advisory fees to be pulled from nonqualified annuities without the fees being recognized as a taxable event, provided that the withdrawal for the fee does not exceed 1.5% of the contract value.[2] Thus, a client may want to consider relocating a portion of taxable investments into an advisory annuity.

Legacy Planning

Advisory nonqualified annuities also can provide strategies for efficient legacy planning. Annuities bypass the probate process, allow natural beneficiaries to control taxable distributions over their life expectancies, and may be used to achieve tax deferral within various trusts.[3] Financial professionals who are unfamiliar with annuities often are surprised to find out there is an entire section of the tax code that covers the rules about how annuities are to be passed to beneficiaries and can be used in legacy planning. Annuities are insurance policies and, therefore, are a beneficiary-designation asset. This means that provided the estate is not the beneficiary, the beneficiaries of annuities will receive the asset without going through the delays and cost of the probate process.[4]

[1]Over the one-, three-, and five-year periods ended December 31, 2018. Peters, Donald. "How You Can Employ a Deft Tax-Efficient Strategy," T. Rowe Price Insights, March 2020.

[2]Private letter ruling 201946002.

[3]26 U.S. Code Internal Revenue Code (IRC) Section 72(S) and (U).

[4]26 U.S. IRC Section 72(S).

Financial professionals who are not familiar with annuities often point out that annuity beneficiaries do not receive the one-time step-up in cost basis when they pass to beneficiaries. This is true, and it's because the owner has received the benefit of tax deferral during his or her lifetime. Annuities are not assets that provide a step-up in cost-basis in order to achieve tax parity with taxable investments during the owner's lifetime. Annuities are treated as income in respect of a decedent. Thus, beneficiaries must pay the taxes the owners were allowed to defer in order to bring the taxation of that asset in line with other assets the owner paid taxes on during life.[1]

As previously stated, tax deferral allows for growth potential without tax drag and without required minimum distributions (RMDs) for owners of nonqualified annuities. Beneficiaries of nonqualified annuities that are individually owned and not within trusts have flexible options on how they can receive their inheritances. Natural beneficiaries have the option to take their inheritances: in a lump sum; within five years; as level lifetime income payments; or as an annual required minimum distribution of the account value over their life expectancies.[2] 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 changed the qualified RMDs *qualified* stretch option for designated beneficiaries, a *nonqualified* stretch may still be an option for natural beneficiaries. This option allows for assets that are not distributed to remain invested and provides beneficiaries some control over taxable income from year to year without having to realize the larger taxable event of a lump-sum distribution.

Annuities owned within irrevocable trusts are another misunderstood or not widely known legacy-planning area.

Finally, annuities owned within irrevocable trusts are another misunderstood or not widely known legacy-planning area where annuities can offer solutions. Most irrevocable trusts are subject to highly compressed tax brackets in which retained income can be taxed at the highest income-tax rates very quickly. An annuity contract will retain tax deferral when owned by a trust if that trust is "an agent for a natural person."[3] 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 PLRs over the years that allow for tax-favorable planning strategies, provided that all trust beneficiaries are natural people, using annuities.[4] An advisory annuity can be used as a solution to balance the dual financial interests of current income beneficiaries and remainder beneficiaries by allowing for tax-deferred growth potential within these types of trusts.[5]

Annuities Can Play a Critical Role in Your Clients' Plans

Pacific Life Advisory is a dedicated team experienced and equipped to assist fiduciary financial professionals with implementing strategies that could take their practices to the next level. Please reach out to a Pacific Life advisory consultant for assistance with case planning and tax-deferred strategies. We look forward to working with fiduciary financial professionals as we continue to offer innovations in the advisory space.

[1] 26 CFR 1.691(a)-1.

[2] 26 U.S. IRC Section 72(S) and PLR 200313016.

[3] U.S. IRC Section 72(U)(1).

[4] Private letter rulings 9120024, 9204014, 9322011, 9639057, 9752035, 19995015, 19993033, 20044917, and 201124008.

[5] Please consult your tax and legal professional for strategies that can qualify for exemptions under 72(q). Financial professionals should be aware of PLR 202031008 which states that distributions from contracts within nongrantor trusts would not qualify for the 59½ exemption for the 10% additional tax under 72(q).

For a case design or more information about how Pacific Life advisory annuities can fit into your clients' plans, please call (866) 441-2354 or send an email to PacificLifeAdvisory@PacificLife.com.

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Pacific Life is a product provider. It is not a fiduciary and therefore does not give advice or make recommendations regarding insurance or investment products.

Variable annuities are long-term investments designed for retirement. The value of the variable investment options will fluctuate so that annuity units, when redeemed, may be worth more or less than the original investment.

Investors should carefully consider a variable annuity's risks, charges, limitations, and expenses, as well as the risks, charges, expenses, and investment goals of the underlying investment options. This and other information about Pacific Life variable annuities are provided in the product and underlying fund prospectuses. These prospectuses should be read carefully before investing.

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 features include lifetime income, death benefit options, and the ability to transfer among investment options without sales or withdrawal charges.

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