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Nationwide Advisory Solutions

Presentation

Nationwide **Advisory Solutions**

Advanced Annuity Planning

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1 General Annuity Uses

May Include…

- + Income Tax Deferral
- + Guaranteed Income/Withdrawal
- + Enhanced Death Benefit
- + Guaranteed Interest
- + Principal Protection
- + Longevity Hedge
- + Creditor Protection

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§ 1035 (Partial)

Partial 1035 Exchange: Dividing Basis and Gain

- Revenue Ruling 2003-76
- Exchange of partial amount tax-free under § 1035
- Cost basis and investment are divided ratably

- Considerations:
  - Distributions from either contract within180 days after the transaction cause the two contracts to be treated as one and will result in LIFO taxation of the distribution.
  - Revenue Ruling 2011-38 (reduced to 180 days, originally 12 months)

Example

- John Smith owns a deferred, non-qualified annuity A
- Cost basis $100K, cash value $150K
- John needs to take a $50K distribution
- Partial 1035 exchange of $75K to deferred, non-qualified annuity B
- Result:
  - Cost basis $50K and cash value $75K in both annuity A and annuity B
  - John takes a $50K distribution from annuity A more than 180 days past the partial 1035 transaction date
  - John realizes $25K which is added to income in the year withdrawn
  - The other $25K is a tax-free return of basis
  - John pays income tax on $25K instead of $50K as long as he waits 180 days

Partial 1035 Exchange to Single Premium Immediate Annuity

+ SPIA must make first payment within 365 days
+ *Revenue Ruling 2011-38: 180 day rule does not apply to payments received as an annuity* (180 day rule still applies to original deferred annuity)
+ A means to distribute from an appreciated, non-qualified, deferred annuity efficiently
+ Income via withdrawal: LIFO treatment – gains are distributed first and are regarded as income.
+ Income received as an annuity (SPIA): Exclusion ratio applies
  - Create a guaranteed stream of income for life
  - Begin to access tax-free cost basis immediately via regular income payments
  - *Immediate annuity must be structured for a term certain of at least 10 years or for a life contingency*

Example

- John Smith(age 75) owns a deferred, non-qualified annuity A
- Cost basis is $105K, cash value is $150K
- John needs an additional $500 per month from his annuity to cover medical expenses
- It would take John nearly 10 years of withdrawals from deferred annuity A before he could access the tax-free cost basis in the contract (at $500 per month or $6,000 per year) (with or without investment gain along the way)
- If John decided to use a partial 1035 exchange to an immediate annuity B to create the needed $500 per month, he would need to exchange $74,289.08 from annuity A.
- Of the amount exchanged, $52,002.36 is cost basis and $22,286.72 is taxable gain – the same 70/30 proportion that exists in the deferred annuity.
- John's $6K annual annuity payments will be partially non-taxable and partially taxable, whereas withdrawals up to the cost basis from the deferred annuity would be fully taxable.

Partial 1035 Exchange to Qualified Long Term Care

- Pension Protection Act § 844(b)
- "Like-kind" exchange may be made from annuity or life insurance policy to "qualified" LTC policy
- "Qualified" defined by IRC § 7702B – describes most LTC policies issued today
- Typically partial exchange to pay annual LTC policy premiums
- Benefits:
  - Exchange is tax-free via § 1035
  - Ratable portion of basis and gain is exchanged
  - Gain portion exchanged is never taxed due to the tax-free nature of LTC benefits
  - LTC premium covered, a portion of taxable gain is permanently removed

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3 Cash Value Below Cost Basis

Example

- Greg Williams owns deferred, non-qualified annuity A (could be CV life policy)
- Cost basis is $100K, cash value is $90K
- How would you address this?
  - Liquidate? No tax is due
  - This is likely a mistake – investment gain, the next $10K is tax-free if kept deferred
  - Investment-Only Variable Annuity (IOVA) could be a solution (low-cost, investments)
  - 1035 exchange, accumulate until cost basis level is met, then liquidate – no tax

4 Payment of Advisor Fees

Private Letter Ruling 101342-19

+ Fees deducted from non-qualified annuity's cash value and remitted to an Adviser cannot be treated as an "amount received" by the owner for purposes of § 72(e)
+ In other words, fees are not to be considered a distribution for tax purposes, fees are considered an expense of the contract
+ Requirements:
    + Fees will not exceed an annual rate of 1.5% of the contract's cash value
    + Fees will only be used to pay for investment advisory services related to this contract
    + Fees are to be paid directly to the Adviser
    + *See the full requirement set on the following slide.*

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Requirements:

- The annuity contract is designed for owners who will receive ongoing investment advice from an investment adviser who is appropriately licensed and in the business of providing investment advice.
- The annuity contract owner will authorize investment advisory fees to be paid periodically to the adviser from the annuity contract's cash value.
- The fees will be determined based on an arms-length transaction between the owner and adviser.
- The fees will not exceed an amount equal to an annual rate of 1.5% of the annuity contract's cash value determined at the time and in the manner provided by the fee authorization but in all events based on such cash value during the period to which the fees relate.
- The fees will compensate the adviser only for the investment advice that the adviser provides to the owner with respect to the annuity contract and not for any other services or accounts, nor reduce fees for other services or accounts.
- While the fee agreement is in place the annuity contract will be solely liable for the payment of the fees directly to the adviser.
- The owner may not pay the fees to the adviser from other accounts or assets nor can they direct the payment of the fees for any other purpose or to any other person.
- The adviser will not receive a commission for the sale of the annuity contract.

Implications

- *Cost basis is not affected*
- Fees will reduce cash value, but not cost basis
- Appreciated, non-qualified annuities: cash value in the form of investment gain is reduced until all gain has been withdrawn

- Fees taken immediately following a partial 1035 exchange are no longer subject to the 180 day rule set forth by Rev. Pro. 2011-38.
- Fees are no longer considered to be a distribution as long as all requirement set forth in the PLR are met (see prior slide)

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Non-qualified Stretch, Restricted

Non-qualified Stretch

- IRC § 72 (s)(2)
- Death proceeds may be paid over a period not to exceed the beneficiary's life expectancy (Single Life Table)
- The first distribution must be taken by the anniversary of death
- Details:
  - New contract established in beneficiary's name
  - No new contributions are permitted
  - Growth is tax-deferred
  - Distributions receive LIFO tax treatment
  - Per PLR 101342-19, Adviser fees are not distributions, cannot count towards distribution req's

1035 Exchange of Inherited Annuity

- Private Letter Ruling 146365-12
- Inherited annuity A can be exchanged to inherited annuity B pursuant to § 1035
- An exchange can be made to inherited annuity B prior to the establishment of inherited annuity A via the annuity claimant statement.
- Company reserves the right to disallow this
- Benefits:
  - Beneficiary can pursue a contract which offers benefits to better suit their needs
  - Ex. PLR 146365-12 – fixed annuities

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Restricted Stretch

- Offered at the discretion of the Company
- Living contract owner may choose to restrict beneficiaries in the following ways:
  - Force the lifetime stretch option
  - Set maximum annual withdrawals to match required distributions
  - Allow for additional dollar amounts to be taken beyond required amounts
  - Allow additional flexibility after specified lengths of time/ at certain ages
  - Remove restrictions at certain ages

Implications

- “Control from the grave”
- “Trust-like” structure of inheritance
- Two lifetimes of tax-deferred growth

- Potential solve for the lack of a lifetime stretch option for non-natural (Trust) beneficiaries

7 Trust-owned Annuities

Trust as an Agent for a Natural Person

- IRC § 72(u)(1)(a)
- Annuity owned by a non-natural person (business, corporation, etc.) will not qualify for income tax deferral
- Gains in the contract will be taxable annually as ordinary income

- IRC § 72(u)(1)(b)
- Annuity owned by a Trust as an agent for a natural person will qualify for income tax deferral
- Income accounting rules of the annuity are followed
- Tax-deferral until a voluntary distribution is taken

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Details & Implications

- Annuity titling: annuitant <u>must</u> be a natural person, owner can then be a Trust
- Trustees are the signors on the contract
- Beneficiaries can be Trust, or natural persons (restricted stretch solution)

- Benefits:
  - Leverage the income accounting rules of the annuity to control the realization of income
  - HNW Grantors, non-Grantor Trusts facing abbreviated tax brackets
  - Types: Revocable, Family, Marital, Special Needs, Charitable Remainder, etc.

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Appendix

- IRS Revenue Ruling 2011-38. (n.d.). Retrieved from : https://www.irs.gov/pub/irs-drop/rp-11-38.pdf
- https://www.kitces.com/blog/a-new-way-to-pay-for-long-term-care-insurance-with-favorable-tax-treatment/
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