



Nonqualified Deferred Annuities



Tips, Traps, and Strategies for Accumulation, Distribution, and Beneficiary Options

This presentation is educational and intended for an audience with a basic understanding of the financial industry.
It is not intended for use with the general public.

Today's Environment

- Financial services industry moving toward advisors being fiduciaries
 - More registered investment advisers (RIAs)
 - Qualified accounts
 - (IRC Sections 401, 408, and 408A)
- Various standards for the term fiduciary



Today's Environment (cont.)

- Some various standards for the term fiduciary
 - State laws, for example,
Uniform Prudent Investor Act (UPIA)
 - Federal statutes, for example,
Investment Advisers Act of 1940
 - Federal or state regulation, for example,
the recent Department of Labor (DOL) rule
 - Principles/rules, for example, CFP Board of Standards,
The American Institute of CPAs (AICPA), Center for
Fiduciary Studies

Today's Environment (cont.)

- Common themes
 - Act in the best interest of the client
 - Based on circumstances
- Circumstances change
 - Monitor
 - Update
 - Document



Agenda

- Basics
- Structure and ownership
- Distributions
- Case studies



Client Concerns

- Client concerns
 - How will taxes affect my savings?
 - What happens when I take distributions?
 - Will taxes affect my beneficiaries?
- Taxes matter
 - Timing and control
 - Determine when and how much
 - Ordinary income versus capital gains

Annuity Basics: Accumulation

- IRC Section 72¹
 - Tax-deferred accumulation
 - Tax-advantaged income – Section 72(b)
 - Deferral for natural persons and trusts for natural persons – Section 72(u)
- **Tip:** As a result of an Income Related Monthly Adjustment Amounts (IRMAA), some retirees exceed certain modified adjusted gross income (MAGI) limits, and pay higher Medicare premiums.

¹26 U.S. Code Section 72 - Annuities; Certain Proceeds of Endowment and Life Insurance Contracts. Legal Information Institute. <https://www.law.cornell.edu/uscode/text/26/72>.

All guarantees are subject to the financial strength and claims-paying ability of the issuing insurance company.

Annuity Basics: Distribution

- Additional 10% tax before age 59½
 - Contract maturity date
 - The date in the contract when payments must commence
 - The contract must be surrendered
 - Taxes due on gain
 - Best suited for longer term
(more than five years) investing
- **Trap:** Aggregation of contracts could affect how Section 72(q) distributions are taxed.

Planning Point: Defer until Later

- Tom and Tara, a couple in their early 50s, are in their peak earning years. Their current taxable income is \$300,000. They will need \$120,000 per year in retirement. Should they *consider* a deferred annuity?
 - Defer investment gains until later.
 - Annuity distributions will be ordinary income.
 - Effective tax rate:
 - Today
 - In retirement

Types of Deferred Annuities

- General Types of Deferred Annuities

Fixed

- Fixed rate
- Index-linked rate

Deferred Income Annuities (not covered)

Variable

- **Tip:** States have “free-look” rules that allow an annuity purchaser to change his or her mind within a certain number of days, often 10. Seniors may have up to 30 days.

Structure of the Contract

- The structure determines who will get what benefit and when
 - Living benefits
 - Death benefits
- Type of contract
 - Owner driven
 - Annuitant driven



Structure of the Contract (cont.)

Parties

- Owner(s)
 - **Benefits and burdens**
- Annuitant(s)
 - **Measuring life only**
- Beneficiary(ies)
 - **Post-death recipient**



Beneficiary Options

The beneficiary of the contract has different options available:

- Natural person
 - Lump sum
 - Five-year
 - Life expectancy
 - Annuitization
 - Spousal continuation
- Entity or estate
 - Lump sum
 - Five-year
- **Trap:** If a trust is the **beneficiary** of a nonqualified deferred annuity, the distribution options available are limited to lump sum or five years.

Planning Point: Maximum Deferral with a Trust-Owned Annuity

- Sara is Sam's surviving spouse.
- She has a credit-shelter trust created with a portion of Sam's assets.
- Her goal is for as much as possible to go to their child, Luke.
- Luke is a successful professor at a local college.

Should the trustee consider purchasing a variable annuity in the trust?

Planning Point: Maximum Deferral with a Trust-Owned Annuity (cont.)

Should the trustee consider purchasing a variable annuity in the trust?

- The trustee of the irrevocable trust, that is, the credit-shelter trust, can purchase an annuity with trust assets.
- Luke, the remainder beneficiary, is named as the annuitant of the contract.
- Recognition of gains in the annuity contract is deferred until a distribution is made.
- At mom's passing, the trust has language that allows the distribution of trust assets in-kind to the remainder beneficiary.
- The transfer of the annuity would be a non-taxable transfer.
- Luke can defer taking distributions until he needs additional resources.

Ownership Changes and Taxation

- Types of changes
 - Addition/deletion of joint owner
 - Transfer to another individual or entity
 - Assignment
- Taxation—general rules, exceptions may apply
 - Contract gains are subject to income tax and/or income assignment at the time of transfer
 - 10% additional tax may apply
 - Gift taxes may apply



Ownership Changes: Exceptions

- Spouses
 - No recognition of gain
 - No gift
 - Includes transfers incident to Decree of Divorce
- Transfers between an individual and his/her grantor trust
- **Trap:** If a child is added to a mutual fund account, a gift is not made until the child takes a distribution for themselves. If a child is added as owner to an contract, there is an immediate gift as well as recognition of any gains.

1035: Allowable Exchanges

IRC Section 1035 allowed for certain like-to-like exchange of insurance contracts.

Life Insurance	Endowment	Annuity	QLTCI
<ul style="list-style-type: none">• Life Insurance/ Life + Qualified Long-Term Care Insurance (QLTCI)• Endowment• Annuity• QLTCI	<ul style="list-style-type: none">• Endowment• Annuity• QLTCI	<ul style="list-style-type: none">• Annuity• QLTCI	<ul style="list-style-type: none">• QLTCI

The Retirement Challenge

Most retirees want to maximize income and minimize taxes.

Annuities can help with:

- Control
 - How income is received
- Timing
 - When income is received
- Tax bill
 - Flexibility in how much and when



Distributions: A Brief History

Before 1982, annuities had certain advantages in addition to deferral. Some existing contracts still may.

- First-in, first-out (FIFO) tax treatment
 - Eliminated in Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA)
- No additional 10% tax before 59½
 - 5% additional tax added by TEFRA of 1982
 - Increased to 10% in Tax Reform Act of 1986 (TRA)
- Annuity ownership passed by will for multigenerational deferral
 - Eliminated by Deficit Reduction Act of 1984 (DEFRA)

Distributions: Today

- LIFO treatment
- 10% additional tax if younger than age 59½ unless exception applies
- Distribution required at earlier of:
 - Age of contract maturity
 - Death
- **Tip:** 10% additional tax applies to gains, including imbedded gains.
- **Tip:** Section 72(t) or Substantially Equal Periodic Payments (SEPP) avoids the 10% additional tax.
- **Trap:** Inflation-adjusted riders may negatively affect Sections 72(q) and 72(t).

Distributions: Fees

- Mortality and expense
 - Deducted from the contract
 - Tax neutral
 - Separate account fees
 - Deducted from the contract
 - Affect return
 - Rider fees
 - Contract value
 - Income base
 - Advisory fees
 - Up to 1.5% are considered non-taxable/non-reportable
- **Tip:** As more “RIA annuities” are used in managed accounts, some advisors pay fees from other account assets, such as cash, to reduce the tax effect.
 - **Trap:** If a rider fee is charged against the benefit, the resulting cost could be more than anticipated.

Distributions: Annuitization

- Lifetime or periodic payments
- Exclusion ratio
- **Tip:** Always know the maturity date of an annuity contract.
- **Tip:** Remember that lifetime payments typically act more like fixed income than growth.
- **Trap:** A qualified longevity annuity contract (QLAC) typically creates ordinary income.



Exclusion-Ratio Treatment

Determine purchase payments into the contract

- Non-variable: Exclusion ratio

- Divide purchase payments into the contract by the expected return

- Variable: Exclusion amount

- Divide purchase payments into the contract by the number of years of payouts
 - Variable payment to payment

- **Tip:** Some contracts offer exclusion-ratio treatment for variable payments based on Term Certain payments, with commutation permitted.

SPIA: Life Only

Client Age 79

Purchases a \$100,000 single-premium immediate annuity (SPIA)

Annuitant life expectancy = 10 years

	Fixed			Variable		
	Annual Income Payment	Excludable Amount (Exclusion Ratio = $\$100,000/\$11,000 \times 10 = 91\%$)	Taxable Amount	Annual Income Payment	Excludable Amount (Exclusion Amount = $\$100,000/10$)	Taxable Amount
Year 1	\$11,000	\$10,000	\$1,000	\$12,600	\$10,000	\$2,600
Year 2	\$11,000	\$10,000	\$1,000	\$11,000	\$10,000	\$1,000
Year 5	\$11,000	\$10,000	\$1,000	\$10,000	\$10,000	\$0
Year 10	\$11,000	\$10,000	\$1,000	\$15,000	\$10,000	\$5,000
Year 11 (still living)	\$11,000	\$0	\$11,000	\$15,500	\$0	\$15,500

Hypothetical example for illustrative purposes only.

Partial Annuitization or Exchange

- Partial:
 - Annuitization of a portion of a contract
 - Exchange of a portion of a deferred annuity contract with another annuity contract
- Favorable tax treatment
 - Exclusion ratio treatment for annuitization
 - For single life or joint lives
 - For a period certain of 10 or more years
 - Deferral for exchange
 - 180 days
- **Tip:** Partial annuitization and exchanges are not permitted by all companies or on all contracts. Always check.

Annuitization vs. Withdrawals

	Income Annuities	Nonqualified Annuity with GMWB	Nonqualified VA – Systematic Withdrawals
Guaranteed Lifetime Payment	Fixed: Yes Variable: Maybe	Yes	No
Flexible Payments	No	With cap	Yes
Legacy	No, although unused premiums may be returned.	Market performance	Market performance
Taxes	Exclusion ratio treatment; Fixed: set Variable: Excludable amount	Market performance 0% to 100% ordinary income	Market performance 0% to 100% ordinary income

- **Tip:** Imbedded gains can affect the exclusion ratio.

- **Trap:** Payments after life expectancy are all ordinary income.

Planning Point: Efficient Annuitization

A number of years ago, Brian and Briana purchased two \$100,000 nonqualified variable annuities. They need some income. As they just sold their vacation home, taxes are a concern.

- Take distributions from either contract
- Annuitize part of one of the contracts
 - Contract A = \$400,000
 - Contract B = \$200,000
- Combination

Reasons for Partial

- Annuity
 - Better factors
 - Additional payment options
- Exchanges
 - Company diversification
 - Investment diversification
- **Trap:** Always carefully consider whether or not additional contract benefits, such as living or death benefits, may be affected.



Distributions at Death

- Death benefits
 - Standard
 - Guaranteed
 - Enhanced
- Potential beneficiary protection
 - Spousal continuation
 - Life expectancy distribution
 - Enhanced earnings
 - Predetermined beneficiary payout option
- **Tip:** Check whether the contract is per stirpes or per capita.

Planning Point: Who Gets Which Assets

Tony has two primary assets: his managed account and his nonqualified annuity. Both are \$500,000 in value. He wants each of his two daughters to be treated fairly, and he plans for each to inherit half of each asset. He also has a \$500,000 brokerage account he will leave to charity. Will this accomplish his desire for each child to receive the same amount?

- Consider the financial situation of each beneficiary
 - Tax bracket
 - Needs
- Goals
 - Protection for beneficiaries
 - Charitable contributions

Post-Death 1035 Exchange

What is a post-death 1035 exchange?

- Tax-free exchange
- Distributions must:
 - Comply with IRC rules
 - Be made at least as rapidly as scheduled under the original inherited contract
 - Be spread over life or life expectancy
- **Trap:** Post-death 1035 exchanges MUST be direct between carriers.
- **Tip:** A beneficiary can combine multiple nonqualified annuities for the same deceased.

Reasons for a Post-Death 1035 Exchange

Why should I consider a post-death 1035 exchange?

- Lower fees
- Different investment options
 - Statement risk or volatility
 - Growth for a younger beneficiary

Check with companies for product, guarantee, and processing restrictions.

- **Trap:** If the five-year deferral option was elected, the life expectancy option is no longer available.

Planning Point: Meet New Goals

Felix is your client. He and Fiona, his aunt, were named beneficiaries of his mother's annuity. They need advice on their distribution options.

- Review the distribution options
- Review goals
 - Felix — wants long-term growth
 - Fiona — wants to delay taking Social Security
- Consider a post-death 1035 exchange

Case Study: Grow Now, Pay Later

Sam and Sarah are in their early 40s. They want the option of retiring in about 20 years. Successful professionals, their combined income is almost \$300,000. They feel that “too much” of their investment earnings go to taxes. They want \$150,000 per year in retirement.

- Consider a low-cost variable annuity
 - Savings will grow tax-deferred
 - Gains are taxed when distributed

Case Study: Growth, Flexibility, and Efficiency

Sean and Sophia are both age 60. They plan to retire in about 6½ years. They are comfortable with investing and want the opportunity for growth. They have sufficient predictable income.

- Purchase a low-cost deferred variable annuity
- Use partial annuitization to create additional income during retirement

Case Study: Control from the Grave

Tom has an older annuity worth almost \$500,000. He wants to leave it to his two children, Tom, Jr., and Tessa. He plans to leave the annuity to a trust. He wants to limit how quickly the children, especially Tom, Jr., receive their inheritances.

- Predetermined beneficiary payout option
 - Select how each child receives his or her share
 - Easy to modify
- Potential for guaranteeing minimum amount

Summary

Nonqualified deferred annuities can help some clients with:

- Tax management during accumulation
- Timing and control of income at distribution
- Meeting legacy goals



Next Steps

1

Identify clients with high incomes or nearing retirement

2

Review the different strategies

3

Meet with clients and develop a plan

4

Implement and monitor

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