Three Annuity Estate-Planning Tips—and Two Traps

Many retirees use nonqualified annuities for tax deferral, to create lifetime income, or as a legacy-planning option. But what happens when the nonqualified annuity owner passes away?

Many retirees choose a nonqualified annuity to defer taxes on invested assets, to create lifetime income, or as a way to secure a financial legacy for their loved ones. While the credited interest and/or gains in a nonqualified annuity do produce ordinary income, careful planning can make a nonqualified annuity a tax-efficient wealth-transfer asset.

Let's consider three ways a nonqualified annuity might accomplish that goal, as well as two common traps to keep clients aware of as they plan.

- **Threshold management.** A retiree wants to time and control recognition of gains to keep income under the various thresholds, such as those that apply to Medicare or the new Senior Deduction. A nonqualified annuity can allow for tax-deferred growth with gains taxed as ordinary income only when distributed. This also means that the account can be rebalanced without a current taxable event. The retiree owns the annuity and can access the funds "just in case" they are needed in retirement.

  If the retiree does not use the funds during life, they can be left to heirs. If the direct beneficiary of the contract is a person, such as a child or grandchild, the beneficiary or beneficiaries may elect to inherit the account, that is, the beneficiary can take annual distributions over his or her Single Life Table fixed-life expectancy. While the distributions are taxed under the last-in, first-out (LIFO) rule, this spreads the taxable amount over a longer period. For example, a child who inherits at age 20 would have 65 years to fully distribute the account.[1]

- **Income to retiree, cash flow for heirs.** A retiree may want to secure additional guaranteed lifetime income. There are many ways to accomplish this using an income annuity, such as a single-premium immediate annuity (SPIA), or a deferred annuity, such as a registered index-linked annuity (RILA) or a variable annuity with an income benefit.

  This guaranteed lifetime income can allow the retiree to confidently spend and enjoy his or her retirement years. At death, any remaining payments or cash value may transfer to a named beneficiary or beneficiaries. Note that the beneficiary of a deferred annuity, such as a RILA or variable annuity, could elect to stretch the account.

- **A possible life insurance boost.** What if the retiree decides the funds are no longer needed for income but still wants to create a significant legacy? The stream of income can be used to pay life insurance premiums, creating a legacy free of both income and estate taxes for a beneficiary (if done correctly).

- **A "pass-in-kind" legacy plan.** What if a retiree wants to create a legacy for heirs, but life insurance is not a viable option? The retiree can use a pass-in-kind strategy to create the desired legacy. A pass-in-kind strategy uses the distribution-in-kind feature of an irrevocable trust to transfer an annuity contract to a remainder beneficiary of the trust. This strategy also can help protect a financially inexperienced heir.

  For example, let's say a parent wants to leave a legacy for—and possibly protect—a child. The parent creates an irrevocable trust, such as a credit shelter or B trust, and names the child as the remainder beneficiary. The parent places cash in the trust. The trustee, often the parent, asks that the trust purchase a nonqualified deferred annuity. The trust owns the annuity and the remainder beneficiary child is the annuitant. The annuity grows tax-deferred.

When the parent passes away, the trust can distribute the annuity "in-kind" to the child through a re-registration of the contract, not triggering a taxable event. The child is now the owner and annuitant and can access the funds at his or her discretion. Remember that if the child is younger than age 59½, there is a 10% federal tax on any interest or gains distributed from the contract. If the child is not yet ready for financial responsibility and the trust provisions allow, the trust can continue to hold the annuity until the child is older.

- **Two trust traps.** Be careful. There are two trust traps for clients to keep in mind as they build their plans. First, if a trust owns or is the beneficiary of a nonqualified annuity and the annuitant passes away, the only distribution options available are lump sum or within five years of the anniversary of death. There is no "see-through," that is, stretch provision for nonqualified annuities, as this provision only applies to qualified accounts. Second, in the pass-in-kind strategy, if the parent is the annuitant of the contract, the contract's beneficiary benefit will distribute into the trust when the parent dies. This means that all gains must be distributed into the trust at best within five years.

ACTIONS YOU CAN TAKE RIGHT NOW

- **Identify retired clients who might need deferral or additional guaranteed income.**
- **Evaluate whether an annuity might provide a solution for a specific client.**
- **Meet with the client and determine whether or not to implement a strategy that includes an annuity.**

Guidance Is Crucial for Savvy Planning

Starting the conversation about estate planning with annuities early can help your clients process the options and make the best decisions for their specific circumstances. Your knowledge could save retirees time, money, and frustration as they plan to meet their income and legacy goals. Be sure to discuss these flexible strategies to help your retiree clients manage future taxes, add guaranteed income to existing plans, or create legacies that protect their loved ones.

A beneficiary benefit is referred to as a death benefit in the contract summary or prospectus.
[1] IRS Publication 590-B, 2024 Version.

Additional Resources and Links

The One Big Beautiful Bill Act on Social Security Taxes: A Deduction – Not a Repeal

Inherited IRA Distributions Calculator

RILAs: An Evolved Approach to Help Prepare for Retirement

Tax Management

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

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