Western & Southern Financial Group

Advanced Markets Matters

Annuities in Trusts

A Financial Professional's Guide

Annuities in Trusts: Expanding Opportunity

Are You Ready to Talk Annuities in Trusts?

All the traditional advantages of nonqualified annuities, plus added ones provided by today's new features, are attracting attention from trustees. Decision makers overseeing various types of trusts are ready to talk. Are you?

Annuity Opportunies

You may already know the benefits commonly offered by individually owned nonqualified annuities:

- Income tax deferral
- Protected lifetime income
- Risk management
- Guaranteed rate options
- Living benefits
- Enhanced death benefit riders
- Access to funds (within limits)
- Exemption from probate

Trust Opportunities

You may not be as familiar with the potential benefits of trusts. These vary by trust type and local laws. They generally include:

- Maximum flexibility in distribution of assets
- Management of trust assets in case of incapacity
- Protection from creditors
- Exemption from probate
- Possible reduction of estate and gift tax

Combining the Opportunities

Utilizing annuities in trusts can leverage the benefits of both. It can provide sound investment options and innovative planning strategies. Read on to get comfortable with this concept and enhance your ability to discus the potential benefits with clients and trustees.

Understanding Trusts: An Overview

A **trust** is a fiduciary relationship. One person holds property for the benefit of another person. The **grantor** creates the trust. The grantor executes a trust document and transfers property to the trust. The **trustee** administers the trust according to the terms of the trust document. The trustee does so for the benefit of the **beneficiary**. The property held in trust is the **trust corpus** or **res**.

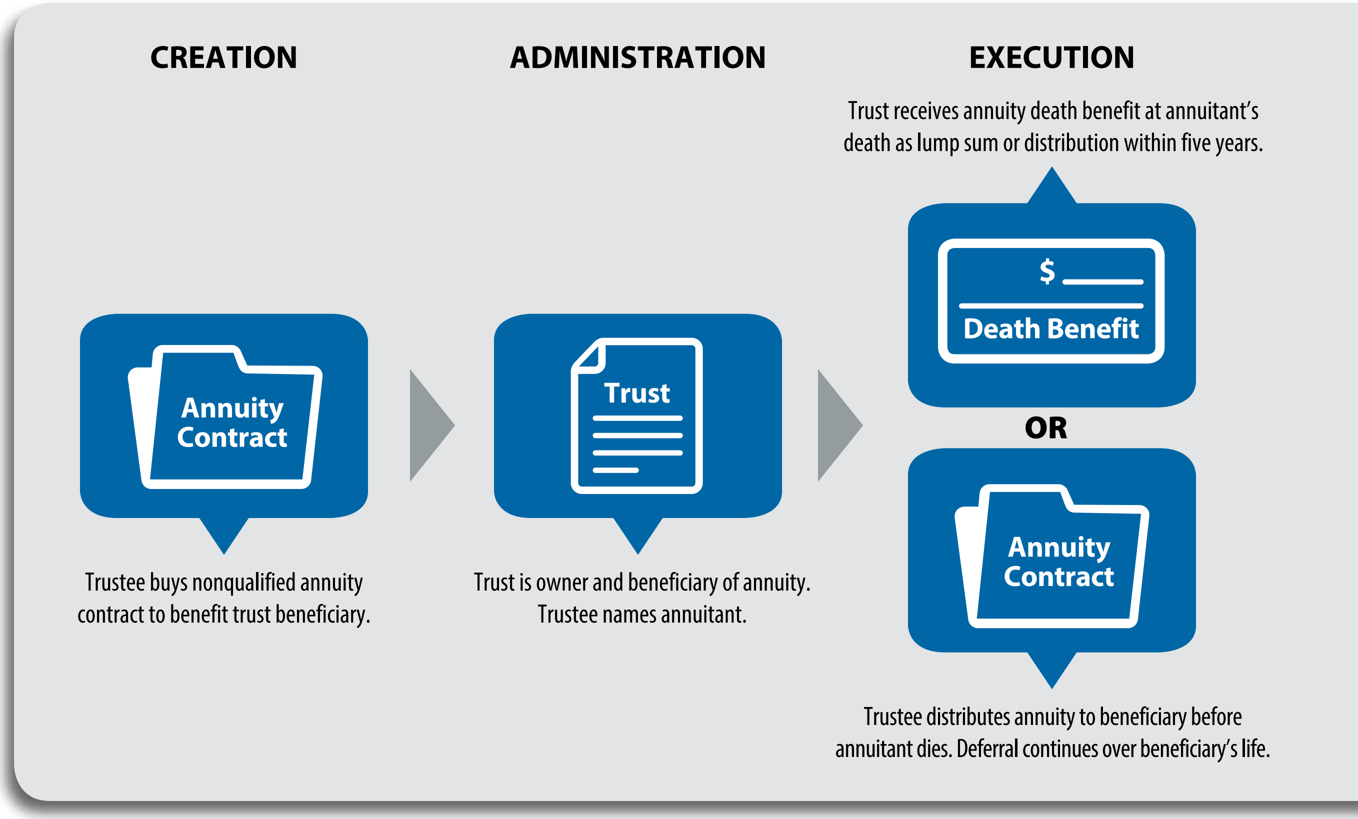
State law controls the creation, operation and termination of a trust.

The grantor may create the trust during their lifetime (an **inter vivos** trust) or by will at death (a **testamentary** trust). Almost any property can be placed in trust. Examples include a personal residence, a closely held business and assets such as stocks, bonds, life insurance, annuities and cash. The trustee receives legal title to the property held in trust.

A grantor who retains the right to revoke or modify the trust creates a **revocable** trust. For income tax purposes, the grantor is treated as the owner of the trust and is taxed on trust income. A revocable trust does not remove the assets in the trust from the grantor's estate.

Alternately, a grantor who relinquishes the right to amend, modify, change or revoke the trust creates an **irrevocable** trust. Property placed in a carefully drafted irrevocable trust is removed from the grantor's estate — and placed beyond the reach of creditors and judgments.

How Does It Work?



Annuities in Trusts: Tax Considerations

Tax Deferral

Annuity contracts owned by trusts that merely hold the annuity contract as an agent for a natural person – i.e., all the beneficiaries are natural persons – are generally treated as annuity contracts for income tax purposes. Thus, income earned on the nonqualified annuity contract each year is not subject to current income tax or to the additional 3.8% net investment income tax.

Taxable income retained by non-grantor irrevocable trusts is subject to comparatively higher trust income tax rates. These trusts reach the highest income tax rate (39.6%) at $12,501 of taxable income (in 2017). In comparison, married couples filing jointly do not reach the 39.6% income tax rate until $470,701 of taxable income (in 2017).

Tax Brackets for 2017

Marginal Rate	Married Filing Joint	Estates & Trusts
10%	0–$18,650	
15%	$18,651–$75,900	0–$2,550
25%	$75,901–$153,100	$2,551–$6,000
28%	$153,101–$233,350	$6,001–$9,150
33%	$233,351–$416,700	$9,151–$12,500
35%	$416,701–$470,700	
39.6%	Over $470,700	Over $12,500

Control over Recognition of Income

In addition, the undistributed gains inside an annuity are not generally defined as trust income under most state trust laws. Accordingly, they do not have to be distributed to current income beneficiaries. This provides trustees with flexibility. They can request distributions only as needed.

Required Distributions at Death

Certain distributions are required upon the death of the holder of a nonqualified annuity contract. If a required distribution is not made, the contract will not be treated as an annuity contract for income tax purposes under IRC Section 72(s).

Key points regarding required distributions at death include:

- Generally, if the holder of the annuity contract dies *before* the annuity starting date, the entire interest must be distributed within five years of the holder's death or over the life or life expectancy of a designated beneficiary.
- If the holder of the annuity contract dies after the annuity starting date, the interest must be distributed as least as rapidly as under the method used by the holder or over the life or life expectancy of a designated beneficiary.
- When an annuity is owned by a non-natural person (such as a trust), the *holder* of the annuity is deemed to be the primary annuitant. Thus, the death of the annuitant will trigger required distributions under IRC Section 72(s).

Any trust that owns a nonqualified annuity issued by Integrity Life or National Integrity Life must also be named as the annuity beneficiary of that contract. Because a trust is a non-natural person beneficiary, the longest period of time that the annuity death benefit payout can be deferred is five years from the annuitant's date of death.

Transfer of an Annuity to a Trust

IRC Section 72 (e)(4)(c) requires that an owner who transfers an annuity for less than full and adequate consideration count as income any gain on the contract at the time of the transfer. So the type of trust – revocable or irrevocable – receiving the transfer is a key distinction:

- When an annuity is transferred to a **revocable trust**, the annuity is not treated as being transferred for income, estate or gift tax purposes. Why? Because there is no transfer. *Ownership* of the annuity remains the same before and after the transfer.
- When an annuity is transferred to an **irrevocable trust**, ownership has changed. The transfer will trigger recognition of all gain on the contract at the time of the transfer.

In-Kind Distribution

The transfer of an annuity contract in kind from a properly structured trust to a beneficiary is not a taxable event. In several private letter rulings the Internal Revenue Service has stated that the distribution of an annuity contract from a non-grantor trust to a trust beneficiary does not constitute a transfer without full and adequate consideration under IRC Section 72(e)(4)(c).* This holds because the trust, in each of these cases, was not an individual for purposes of that section. The trust beneficiary simply becomes the owner of the contract and assumes the trust's cost basis in the annuity. Tax deferral continues for the new owner. The new owner can name a designated beneficiary to continue the deferral for as long as permitted.

Annuities in Trusts: Taxation At-A-Glance

Revocable Trust	Non-Grantor Irrevocable Trust
Grantor retains right to modify or revoke the trust	Grantor relinquishes right to modify or revoke the trust
Treated as owner of trust for income tax purposes — income subject to tax at grantor's tax rates using grantor's Taxpayer Identification Number (TIN)	Income subject to tax at higher trust tax rates — trust must have its own TIN
Does not remove assets from grantor's estate	Removes assets and appreciation from grantor's estate
Transfer of annuity to trust is nontaxable	Transfer from grantor to trust is a taxable event
In-kind transfer of annuity contract from trust to any beneficiary is a taxable event (unless to grantor)	In-kind transfer of annuity contract from trust to beneficiary is nontaxable event

* A private letter ruling has no reliance value other than for the particular taxpayer receiving the ruling.

Selected Types of Trusts: Quick Reference

	Revocable Trust	Credit Shelter Trust (CST)	Charitable Remainder Trust (CRT)
Description	Created during life and can be changed or revoked at any time prior to grantor's death or incapacity. Becomes irrevocable upon the grantor's death.	Created to hold assets equal to the federal estate tax exemption amount ($5.49M in 2017) in trust upon the death of the first spouse. May provide income for the surviving spouse while maintaining trust assets for remainder beneficiaries (children of the married couple or children from a previous marriage) and preventing surviving spouse from having full control of the assets.	Designed to split gifts between a charity and a non-charitable beneficiary.
Purpose	Provide asset management in the event of incapacity, avoid probate, ensure privacy and avoid ancillary administration of assets held in other states.	Ensure couples likely to be subject to estate tax can take advantage of the federal estate tax exemption amount. Could have been established prior to availability of portability or after to ensure assets remain for benefit of children, shelter appreciation of assets, provide creditor protection and/or permit professional management.	Donate appreciated assets with low basis without incurring capital gain taxes while enjoying other tax benefits, receiving an income stream for a term of years or for life and benefiting a charity.
Tax Implications	Grantor is treated as the owner of the trust and all income of the trust is taxed to the grantor at the grantor's tax rate. Transfer of property to the trust does not result in gift tax. Property in trust is includable in the grantor's estate.	Assets placed in trust, and all appreciation, are removed from the estate of the surviving spouse upon the death of the surviving spouse.	Donor avoids capital gain taxes, receives charitable income tax deduction and removes asset from donor's estate. CRT does not qualify as an agent for a non-natural person and does not receive nor need the annuity's tax deferral. Trust ownership of annuity does not disqualify its status as a CRT.
Use of Annuity	Even though annuity contracts already provide some benefits similar to those provided by a revocable trust, such as probate avoidance, there may be other valid planning reasons for a revocable trust to be the owner. Thus, trustees may purchase an annuity for any of the reasons an individual would — tax deferral, protected lifetime income, risk management or protection from creditors.	A single premium immediate annuity (SPIA) may be an appropriate financial vehicle for paying annual income to the trust's income beneficiary (surviving spouse) and allowing the trustee to concentrate on investing the other assets for growth for remainder beneficiaries (children). The trustee may purchase a deferred annuity with the surviving spouse as annuitant for liquidity at the surviving spouse's death or purchase a deferred annuity for each remainder beneficiary as the annuitant of his or her own annuity with the intent to distribute the annuity contracts at the death of the surviving spouse.	Trustee may consider an annuity for reasons such as guarantees, rider benefits, and income accounting rules. In most states, undistributed gains inside an annuity are not defined as trust income and need not be distributed currently to the income beneficiary. Especially with a net income make-up charitable remainder unitrust (NIMCRUT) – a CRT that need only distribute income actually earned as opposed to having to distribute the required payout each year – the nonrecognition of income can allow a trustee to accumulate more for later distribution (usually as donor nears retirement age).

Annuities in Trusts: Recognizing Opportunity

Trusts holding today's nonqualified annuities may offer significant tax, spendthrift, diversification and income protection opportunities.

Of course, annuities may not be appropriate for all types of trusts. Factors such as the purpose of the trust, the terms of the trust and the controlling state law must guide the decision making.

Considering a wide range of alternatives serves the best interests of clients. And in annuities in trusts can be one of those alernatives of value.

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Financial Strength 1888 Heritage

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Payment of benefits under the annuity contract is the obligation of, and is guaranteed by, the insurance company issuing the annuity. Guarantees are based on the claims-paying ability of the insurer. Product approval, availability and features may vary by state. Earnings and pre-tax payments are subject to income tax at withdrawal. Withdrawals prior to age 59½ are generally subject to a 10% IRS penalty tax.

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