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Annuities in Trusts

7 Key Points for Financial Professionals

Different sets of rules, each complex, govern annuities and trusts. Mixing the two can result in unexpected and unintended tax and distribution consequences. Building your knowledge of the basics is essential.

Can a nonqualified annuity owned by a non-natural person (such as a trust) still be treated as an annuity contract for income tax purposes?

Section 72(u) of the Internal Revenue Code (IRC) provides that a nonqualified annuity contract owned by a non-natural person (such as a trust) will generally not be treated as an annuity contract. Thus, a valuable tax advantage – the deferral of income tax – may be lost. An exception is provided when the nonqualified annuity contract is held by a trust as an agent for a natural person. For a trust to qualify as an agent for a natural person, all the beneficiaries – both income and remainder as well as current and future – must be natural persons. If a trust is the owner of a nonqualified annuity issued by Integrity Life or National Integrity Life, the trust must be named as the beneficiary of the annuity as well.

Why might clients or their other advisors want a trust to own a nonqualified annuity?

There may be several reasons for having a trust own a nonqualified annuity contract.

- **Revocable Living Trusts —** One of the main reasons for clients to establish a revocable living trust is to minimize estate administration costs and delays at death by avoiding probate. This is not necessary in the case of an annuity, because annuity death benefits and contract values pass to beneficiaries by contract and not through probate. However, there may be other valid planning reasons for clients to have their revocable living trust as the owner of a nonqualified annuity contract, such as control, management, incapacity planning, etc.
- **Irrevocable Trusts —** Some trustees of irrevocable trusts used for estate tax purposes may be attracted to the security and protection offered by annuities. Others may be interested in the tax deferral provided by nonqualified annuity contracts, since non-grantor irrevocable 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).

What is the difference between a grantor trust and a non-grantor trust?

All trusts are created by a grantor or grantors. A trust is a grantor trust if the grantor retains certain powers and control over the trust administration and property, such as the ability to revoke the trust. As a result, the grantor is considered to be the owner of the trust and is taxed on its income. Assets placed in a revocable trust are not removed from the grantor's estate. Revocable trusts are grantor trusts and do not need a separate tax identification number (TIN) until the trust becomes irrevocable upon the death of the grantor. A non-grantor trust is one in which the grantor relinquishes control over the assets placed in the trust and, if properly structured, thus removes the assets and any appreciation in value from the grantor's estate. An irrevocable trust is generally an example of a non-grantor trust. An irrevocable trust is taxed on its income and requires a separate TIN. An intentionally defective grantor trust (IDGT) is a hybrid trust. An IDGT is an irrevocable trust designed to remove assets from the client's estate but that intentionally fails to remove such assets for income tax purposes. Thus, an IDGT is also a grantor trust. Even though the income is taxed to the grantor, an IDGT does require its own TIN.

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What happens if an existing nonqualified annuity is transferred to a trust?

It depends on the type of trust. IRC Section 72(e)(4)(C) provides that an individual who holds a nonqualified annuity contract and transfers it for less than full and adequate consideration must include any gain on the contract in income at the time of the transfer. In the case of a transfer to a revocable grantor trust, the annuity is not treated as being transferred for income, estate or gift tax purposes because there has been no transfer. The ownership of the annuity is the same before and after the transfer. In the case of a transfer to an irrevocable non-grantor trust, such a transfer will trigger recognition of all gain on the contract at the time of the transfer. In the case of a transfer to an IDGT, the answer is not clear. Clients should consult a tax advisor.

Must gain be recognized when a trust transfers a nonqualified annuity contract to a beneficiary?

The Internal Revenue Service (IRS) has ruled that the transfer of a nonqualified annuity contract in kind from a non-grantor trust to a beneficiary is not a taxable event.* The trust beneficiary simply becomes the owner of the contract and assumes the trust's cost basis in the annuity. Tax deferral would continue for the beneficiary.

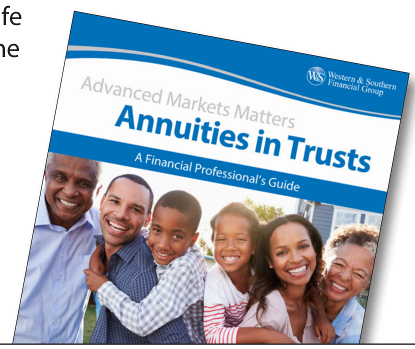
Who is treated as the "holder" of a nonqualified annuity contract held by a trust for purposes of required distributions under IRC section 72(s)?

IRC Section 72(s) requires that certain distributions must occur upon the death of the holder of a nonqualified annuity contract or the contract will not be treated as an annuity contract for income tax purposes. When a nonqualified annuity is owned by a trust, the holder of the annuity is deemed to be the primary annuitant. Thus, any nonqualified annuity contract owned by a trust – whether annuitant-driven or owner-driven – must provide that the entire interest in the annuity be distributed upon the death of the annuitant in accordance with the rules of IRC Section 72(s). 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 date of death of the annuitant.

What additional documentation is needed when a trust will own a nonqualified annuity?

When a trust will be the owner of a nonqualified annuity contract issued by Integrity Life or National Integrity, the Entity Ownership Certificate (EOC) form should accompany the application. The EOC form requires that a copy of the front page of the trust, all pages naming the trustees and successor trustees, and the signature page of the trust be included with the form. There is no need to send a copy of the entire trust document.

For more information, see the Financial Professional's Guide to Annuities in Trusts and visit WSFinancialPartners.com



* PLR 199905015 states that the distribution of an annuity contract to a trust beneficiary does not constitute a transfer without full and adequate consideration under IRC Section 72(e)(4)(C) because the trust is not an individual for purposes of that section. See also PLR 200449014. A private letter ruling has no reliance value other than for the particular taxpayer receiving the ruling.

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