New Opportunities in Creative Estate Planning: Hybrid Annuities

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Introduction

- Tax Code has long standing rules for annuitized contracts
- Rules modified in the 1980's to accommodate deferred annuities
- Result? Two Rulebooks for Annuities

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Introduction

- Due to illiquidity of traditional annuitization, most planning done with deferred contracts
- Advent of Hybrid annuity products reopens the door to old annuitization tax rules

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Agenda

- Introduction to Hybrid Annuities
- Five Case Studies

Variable Annuities

- Long term investments
- Retirement income vehicles
- Fees
- Value can fluctuate

To decide if a variable annuity may be right for you, consider that an annuity's value can fluctuate, have different associated costs, and that all guarantees, including those for optional features, are backed by the claims-paying ability of the issuer.

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Annuity Income Hybrids

- New enhancements and product innovations in development
- Geared for annuity owners needing more income flexibility
- Combines the best features of annuity-income alternatives
- Income hybrid riders come with an additional cost

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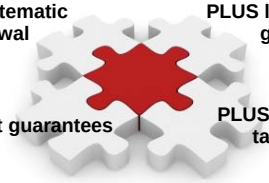
Income Hybrids

Start as systematic withdrawal

PLUS lifetime income guarantee



PLUS market guarantees

PLUS annuitization tax benefits

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Benefits

- Tax-advantaged withdrawals
- Payments guaranteed for life and access to additional cash
- Liquidity and flexibility
- Monthly statement reporting and daily account values
- Automatic portfolio rebalancing and reallocation of assets
- Dollar cost averaging*
- Performance reporting

* Note that dollar cost averaging does not guarantee a profit or protect against a loss.

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Compare the options

Systematic withdrawals

CONS
No lifetime income
Tax inefficient

PROS
Growth potential
control
Death benefits

Annuitization

PROS
Lifetime income
Tax efficient

CONS
Cede assets
Loss of control
No growth potential

Income hybrid
- Lifetime income
- Tax efficiency
- Control
- Growth potential (variable)
- Death benefits

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Case Study 1- Special Needs

Profile
- Jim and Anita, retired
- Their Special Needs son Grant lives with them
- They have a special needs trust as part of their will – to be funded at the second death
- Goal: guaranteed income stream that will continue for Grant

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Case Study 1- Special Needs

The Setup

- **The need for guaranteed income indicates an annuity might be appropriate**
- **If they leave a deferred annuity to the trust then the 5 year rule applies – no continuing income for Grant**
- **An income hybrid avoids this rule**

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Case Study 1- Special Needs

The Nelsons purchase a Hybrid contract (joint owners) naming Grant as the Annuitant, and a trust is named as beneficiary. Additionally, Anita is named as secondary life on the contract in the event she outlives Grant.

As long as Grant is alive, Jim and Anita will enjoy the tax-efficient income until they both pass away.

At death the Hybrid contract and ongoing payments will transfer to the trust for the remainder of Grant's life.

The Trustee will direct payments to Grant's providers as needed, over and above any government payments.

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Case Study 1- Special Needs

Benefits to Jim and Anita	Benefits to Grant
• Tax advantaged, guaranteed income for both of their lives • Undistributed gains accumulate tax deferred • At their deaths these benefits pass to the trust	• While Grant is alive the trust receives the payments and can use them for Grant's benefit • The trust and annuity do not affect Grant's ability to qualify for assistance • At Grant's death the contract has a death claim and can distribute FIFO for residual trust beneficiaries

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Case 2 – By-Pass Trust/Growth

Profile

- Wendy, widowed, mother of two adult children
- Beneficiary of a simple By-Pass trust established by her husband
- The trust mandates that she receive all income
- Wendy does not need income, but likes the idea of guaranteed investments

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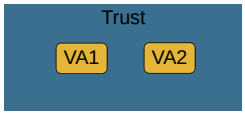
Case 2 – By-Pass Trust/Growth

The Setup

- The trust buys 2 deferred annuities
- Each annuity has one of her children listed as annuitant
- The trust is the contract beneficiary
- A living benefit accumulation rider is added to the contracts for an extra fee



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Case 2 – By-Pass Trust/Growth

The Results

- While Wendy is alive the contracts grow tax deferred.
- At Wendy's death the trust ends and assets go to her two children
- The contracts are distributed tax deferred to the children
- The children use the living benefit income to fund their retirement

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Case 3 – By-Pass Trust/Income

Profile

- Wilma, widowed, mother of two adult children
- Has a simple By-Pass trust from her husband
- She would like to maximize income
- She is interested in annuity guarantees
- Remaining assets will go to her two children

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Case 3 – By-Pass Trust/Income

The Challenge

- If Wilma buys a deferred annuity, then she may face a 10% additional tax
- Tax applies to withdrawal of gains (IRC Sec 72(q)(1))
- Exceptions listed in IRC Sec 72(q)(2) – death, age 59½, etc.
- Query – trust is owner – can trust be age 59½?

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Case 3 – By-Pass Trust/Income

The Solution

Additional tax does not apply to an immediate annuity

Wilma can use an income hybrid as an immediate annuity

Contract Structure -

- Trust is owner
- Trust is beneficiary
- Wilma is Annuitant

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Case 3 – By-Pass Trust/Income

The Results

- **Wilma enjoys the guaranteed income and tax deferred growth via the trust**
- **At her death the contract is distributed in two parts to her two children**
- **Contract distributions will FIFO**

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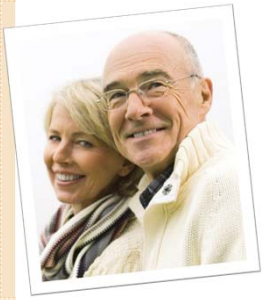
Case 4 – Multigenerational income stretch

Profile

- Bruce and Suzanne Foster
- Both retired at age 65
- Both want to ensure they have income to last their retirement
- Want to pass a portion of their estate to their daughter, Julia, their granddaughter, Delaney, and any children Delaney may have.



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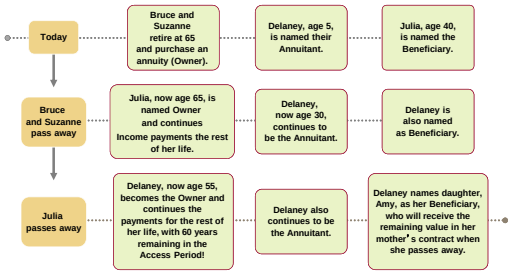
Case 4 – Multigenerational income stretch



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Case 5 – Lifetime Gift

Profile

- **Tom, a widower, has heard about the future gift exemption limits**
- **He has an old annuity, $300,000 basis, $1,000,000 value he would like to give to his two children**

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Case 5 – Lifetime Gift

- **Problem 1 – there is one contract and two children – how to split the contract?**
- **Problem 2 – IRC Sec 72(e)(4) says that if he makes this gift he will pay income tax on the deferred gains**

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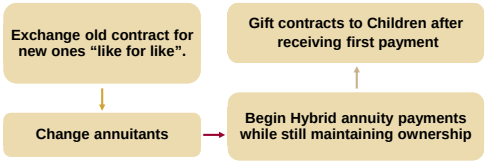
Case 5 – Lifetime Gift

- **Problem 1 – Solution – 1035 the existing single contract into two new contracts**
- **Problem 2 – Solution – change annuitants on new contracts to his children – one for each contract**
  - **b) start income hybrid**
  - **c) effect the ownership change**



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Case 5 – Lifetime Gift

The Results

- **No income tax event for the gift**
- **Asset is removed from Tom's taxable estate**
- **Children enjoy a guaranteed lifetime income and potential tax deferred growth**

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Summary

- Using Income Hybrids to address estate planning issues CAN make annuities a powerful planning tool in this area of your practice.
- Income Hybrids combine the best features of traditional withdrawal benefits and annuitization.
- Unlike deferred annuity contracts, when using income hybrid design, a different set of rules apply under the tax codes that specifically address the uses of immediate annuities.
- Being familiar with these unique solutions and how income hybrids can be used in a variety of trusts, and for lifetime gifting can help to grow your business and set you apart from the competion!

Questions?

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Important Information

Annuities are long-term investment vehicles designed for retirement purposes. Annuities can offer tax deferral, lifetime income, and death benefits to help meet financial needs and goals. Early withdrawals are subject to surrender charges. Withdrawals are subject to ordinary income tax, and if taken prior to age 59½, a 10% IRS penalty may also apply. Withdrawals will reduce the death benefit and cash surrender value.

Variable annuities are long-term investment products designed for retirement purposes and are subject to market fluctuation, investment risk and possible loss of principal. Variable annuities contain both investment and insurance components, and have fees and charges, including mortality and expense, administrative and advisory fees. Optional features are available for an additional charge. The annuity's value fluctuates with the market value of the underlying investment options, and all assets accumulate tax-deferred. Withdrawals of earnings are taxable as ordinary income and, if taken prior to age 59½, may be subject to a 10% federal tax penalty. Withdrawals will reduce the death benefit and cash surrender value.

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