Innovative Uses of Variable Annuities for Legacy Planning

by Philip Herzberg, CFP®, CTFA, AEP®

Philip Herzberg, CFP®, CTFA, AEP®, is a client adviser for The Lubitz Financial Group in Miami, Florida. He is president of FPA of Florida, past president of FPA of Miami, and an executive board member of the Estate Planning Council of Greater Miami.

How can variable annuities—a popular yet complex retirement planning tool—be used for your clients' tax and legacy planning? Know that leveraging variable annuities for tax deferral may be most sensible for high-net-worth clients who have already maxed out their other tax-advantaged options, such as 401(k)s and IRAs.

Traditionally, variable annuities did not offer diverse and viable estate planning options. With older annuities, the insurance company (rather than your clients' estates) typically kept whatever money was left in the contract when the client passed away. Now, however, you can have clients add riders to variable annuities that permit them to leave part of the annuity to their heirs, albeit sometimes in exchange for a lower regular payout.

Although the investment value of variable annuities can grow tax-deferred over a long time for your client owners, their descendants may not be as fortunate. Be cognizant that your clients' beneficiaries may owe substantial income taxes on some types of variable annuities, depending on the contractual arrangement.

Seek the guidance of appropriate tax, legal, and other professional advisers when carefully assessing all income tax ramifications and legacy planning aspects of a variable annuity. Collectively, you can decide if a variable annuity would be a viable vehicle in fulfilling your clients' investment goals and estate planning intentions.

"Be cognizant that your clients' beneficiaries may owe substantial income taxes on some types of variable annuities."

Tax-Optimized Trusts

Planning ahead with innovative strategies is essential to maximizing your clients' asset growth and wealth transfer. Be aware that distributions from non-qualified annuity contracts, to the extent not excludible from income, will generally be subject to the 3.8 percent Medicare tax and investment income for taxpayers with modified adjusted gross income (MAGI) over $250,000 in the case of married couples filing jointly and qualifying widow(er)s with dependent children, or $200,000 in the case of individual filers.

Trusts have become increasingly significant in tax planning and protecting how your clients pass on their financial assets and other property to future generations. A new generation of Investment-Only Variable Annuities (IOVAs) can be used within trusts to help clients build tax-deferred wealth, enhance diversification, and manage volatility.[1] These IOVAs also can benefit your clients by providing control over any distributions the trusts make, potentially minimizing the tax burden to their remainder beneficiaries.

Understand that for longer asset accumulation periods, the low-cost IOVAs offer greater relative upside potential compared to the increase in downside risk in conventional variable annuities with a guaranteed income rider, such as a guaranteed lifetime withdrawal benefit (GLWB).[2] They are deemed to be more attractive to clients who plan to use a deferral period to accumulate assets before withdrawing income from the IOVAs. Similarly, as the guarantee in traditional variable annuities is more likely to become binding over extended distribution periods, clients with lower expected longevity will tend to prefer the IOVAs.

Leaving a Lasting Legacy

Your clients may desire to leave the best legacy possible. Yet, when it comes to conventional variable annuities, the choices your beneficiaries have upon your death may have some restrictions and drawbacks. Once annuitization occurs, beneficiaries lose a measure of control of the money.

The stretch provision enables non-spousal beneficiaries of an annuity contract to stretch distributions by taking systematic payouts over a period not to exceed their life expectancies.[3] This feature spreads out the taxable implications of the disbursements over a longer time period, allowing beneficiaries to keep assets invested on a tax-deferred basis to the extent permitted by current law.

"Once annuitiziation occurs, beneficiaries lose a measure of control of the money."

Stretching can also give descendants greater control over the taxation of their inherited assets by allowing them to pay taxes only as they take their voluntary and required distributions. Some variable annuities give beneficiaries the unique option of continuing tax-advantaged payments while accessing a tax-free lump sum.

Unless restricted, your clients' non-spousal beneficiaries may withdraw additional amounts beyond the required minimum distributions in any year. They have 12 months from the non-qualified variable annuity owner's date of death to establish the stretch distribution for the portion of the inherited contract value. For qualified variable annuities, payments begin by no later than December 31 of the year following the annuity owner's death.

Be mindful that the stretch is designed for variable annuity owners who will not need the assets for their own retirement needs. Changes to current tax law during the distribution period may significantly impact its outcome, including a beneficiary's ability to maintain estimated distributions.

The Restricted Beneficiary Option

Think about a restricted beneficiary feature when your clients are concerned about transferring their variable annuity assets to spendthrift beneficiaries or heirs with limited financial experience or unique circumstances.[4] Your clients can elect a full restriction or restrict only a portion of the assets for a specific beneficiary.

The restricted beneficiary feature may interest clients who wish to leave a structured legacy without the expense of setting up a trust. This variable annuity option may also help to safeguard clients who have minor beneficiaries or beneficiaries with special needs.

Remember to do an annual review of your clients' beneficiary designations to verify that their legacy intentions are up-to-date. ■

Endnotes

1. See Lawrence Greenberg's December 2014 article, "Wealth Management—This New Year, Help HNW Clients Plan Ahead with Tax-Optimized Trusts," posted in the Jefferson National Knowledge Bank (www.jeffnat.com/knowledge-bank) for more on IOVAs.
2. See Wade Pfau's May 2015 Jefferson National whitepaper "A New Approach to Retirement Income: Next-Gen vs. Traditional VAs."
3. See the 2014 Fidelity Investments document "Stretch the Tax-Deferral of Your Low-Cost Variable Annuity."
4. See "Controlling a Legacy" from the Transamerica Advanced Markets Literature Library.