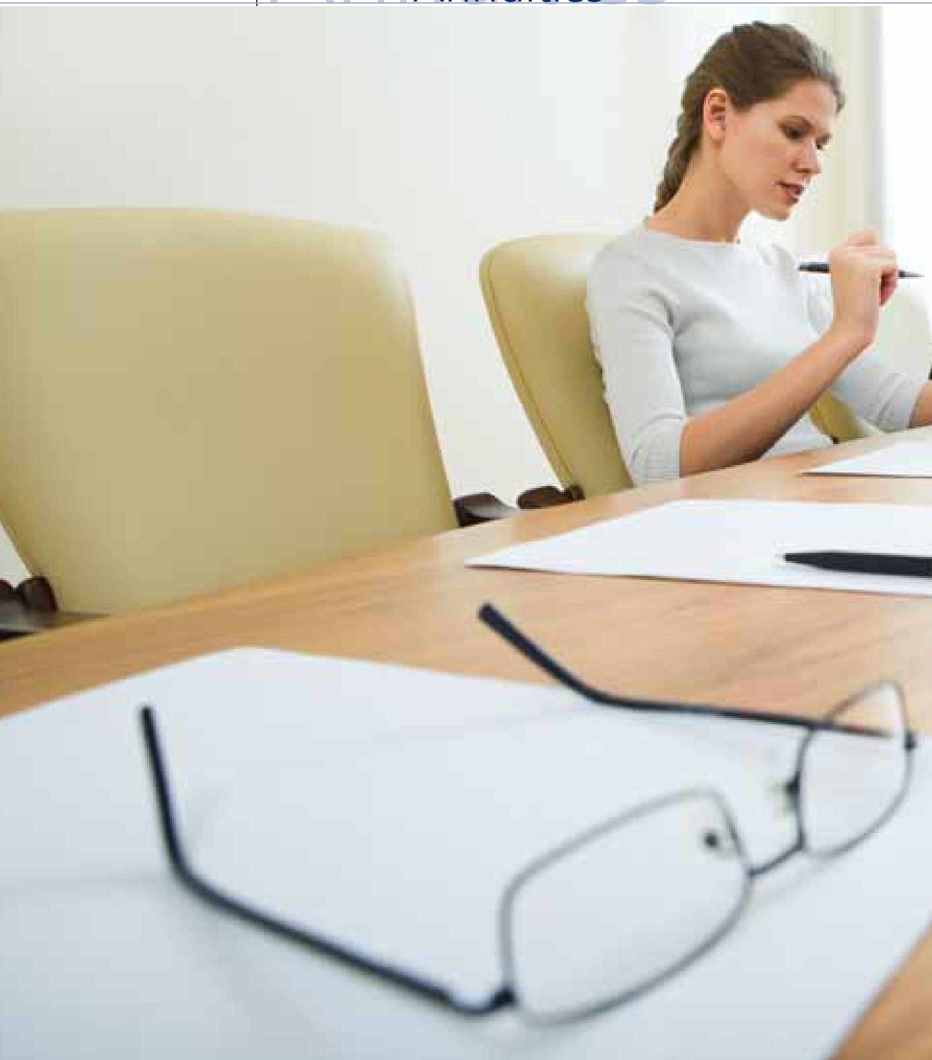
White Paper

Annuities As Trust Assets



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SHOULD A TRUST PURCHASE AN ANNUITY AS AN ASSET FOR ITS BENEFICIARIES?

This question is an interesting one with many facets. Trustees should consider a number of issues before purchasing an annuity, including: the terms of the trust, the ages and health of the beneficiaries, the asset management expertise of the trustee, the type of annuity, how any growth in the annuity will be taxed and the length of time the trust is likely to last. This white paper will address some of these issues.

When considering the purchase of an annuity, trustees should get answers to these fundamental questions:

(1) Does purchasing an annuity result in favoring one beneficiary over others?

(2) Is the annuity a prudent asset considering the other assets the trust owns?

(3) Are the tax consequences and costs of owning an annuity favorable to the trust and its beneficiaries?

In making a decision, the trustee should consider consulting with the trust's tax and legal advisors.

Trustees' Legal Duties

In most states trustees are considered "fiduciaries" and are held to a high standard of conduct. When a trust has multiple beneficiaries, unless the trust document states otherwise, the trustee has a duty to treat each beneficiary fairly. That means the trustee can't manage the trust's assets in a way which favors some beneficiaries (or classes of beneficiaries) over others.

Most states have adopted legal standards to guide trustees on how to make investment decisions. These standards are usually included in the state's version of the Uniform Prudent Investor Act. Generally, unless the trust states otherwise, the trustee is required to invest the trust assets as a prudent investor would and to manage them as a portfolio with an overall investment strategy that has risk and return objectives reasonably suited to the trust. The portfolio of assets should be diversified and invested at a reasonable cost.

Who Are The Beneficiaries And When Do They Get Their Benefits?

The identity of the beneficiaries and when they are entitled to receive their benefits is usually important. Many trusts have two or more classes of beneficiaries. Beneficiaries in different classes usually are entitled to receive their benefits at different times. For example, many trusts have one or more "income" beneficiaries and possibly several "remainder" beneficiaries. Income beneficiaries generally are entitled to receive an annual distribution of the income the trust has earned during the year. Income beneficiaries may be entitled to receive the trust income annually for life or for a specified number of years. After the income interest ends, the trust document may direct the trustee to distribute all left over trust assets to the remainder beneficiaries.

When a trustee purchases a tax-deferred annuity, it may be favoring one or more remainder beneficiaries over the income beneficiaries. That's because a tax-deferred annuity may not produce any income that can be distributed to the income beneficiaries. Growth in the annuity's value may be "reserved" for the remainder beneficiaries without providing any benefit to the income beneficiaries. Whether this is the case usually depends on how the trust is drafted and how it defines the word "income." Similarly, trust assets used to purchase an immediate annuity produce income which will be distributed to the income beneficiaries. But they probably will not produce any investment growth which will be eventually distributed to the remainder beneficiaries. Absent specific language in the trust, annuities in trusts with multiple layers of beneficiaries can be problematic.

These problems may not be present when the trust has only one individual as its beneficiary. If the same individual is both the income and the remainder beneficiary, there is unlikely to be any conflict between beneficiaries. Subject to the terms of the trust, it may be prudent for the trustee to purchase a tax-deferred annuity to minimize the income taxes on any growth in the annuity's value over the years. When the trust terminates, the trustee may be able to transfer the annuity's ownership directly to the beneficiary. Tax-deferred annuities can be a good fit for a simple trust with only one beneficiary. Sometimes a more complex trust can be segregated into separate shares—one for each beneficiary. When each beneficiary's share of the trust assets is managed separately, the trustee may be able to purchase separate annuities for each beneficiary. When a beneficiary's interest in the trust ends, his/her annuity could be transferred to them individually as part of their terminating distribution.

Income Taxes On Annuity Growth

Congress established the current federal income tax rules for non-qualified annuities in 1986. IRC Section 72 states that for annuities purchased after February 28, 1986, federal income tax deferral is not available when the annuity is owned by a non-natural person.[1] Non-natural persons include C corporations, Subchapter S corporations, Limited Liability Companies (LLCs), and many trusts.

There is an exception to this general rule when a non-natural person owns the annuity as an "agent" for a natural person. If the trust is the legal owner of the contract but a natural person is the annuity's "beneficial owner," then the trust can be deemed to be acting as that person's agent.[2] Thus, a trust may avoid income taxation on growth in the annuity when it is acting as a beneficiary's "agent." Unfortunately, neither Section 72 nor its regulations explain when an agency relationship exists between a trust and one of its beneficiaries. Whether the trust is an "agent" for the beneficiary depends on the facts of the case.

The 10% Penalty On "Early" Distributions

Another income tax issue trustees need to be aware of is the potential application of a penalty tax on "early" annuity distributions. IRC Section 72(q) defines "early" distributions as those which are made to the "taxpayer" prior to attaining age 59 ½. When an annuity is owned by a trust, who is the "taxpayer" for the purposes of determining if there is a 10% penalty?

Some experts believe it is logical to look to the age of the annuitant to determine if a 10% penalty tax should be applied. Others believe that when the trust is a "grantor" trust, then the age of the grantor should be used. Still others believe the age of the trust beneficiaries is the appropriate measure. If this is the case, do all beneficiaries need to be over age 59 ½ for the exception to apply? Unfortunately, neither Section 72(q) nor the regulations provide clarity on this question. Consequently, there is significant confusion over whether the 10% penalty tax can be avoided when the trustee makes distributions from a trust-owned annuity. A potential solution might be for the trustee to distribute the annuity contract to a beneficiary before making any withdrawals from the annuity.

[1] IRC Section 72 (u)(1)

[2] H.R. Conf. Rpt. No. 99-841, reprinted in 1986-3 CB Vol. 4 401

Death Of The Annuitant

A core component of every annuity is the person on whose life the contract is based. This is the annuitant. When a trust owns an annuity, the annuitant is generally deemed to be the "holder" of the contract. When the annuitant / holder dies, IRC Section 72(s) sets forth the distribution rules. Here's a summary of those rules:

- If the holder dies after the annuity starting date, the remaining value must be distributed at least as rapidly as the distribution method being used at the holder's death.
- If the holder dies before the starting date, the entire interest must be distributed within 5 years. (There is an exception to the five year rule if a designated beneficiary makes an election within one year of the holder's death to receive the proceeds over his/her life expectancy. If the trust is the annuity beneficiary, this election is not available because, as a non-human, a trust can't satisfy qualifications for a designated beneficiary.)
- If the holder's surviving spouse is the designated beneficiary, he/she has the ability to roll the contract over into his/her own name and thereby continue the annuity contract. Of course, when a trust owns the contract, this rollover option isn't available because as the holder a trust cannot have a surviving spouse.

In general, then, when a trust owns an annuity and the annuitant dies, the annuity balance must be distributed within five years of the annuitant's death. Increased distribution flexibility could potentially be increased if the annuity is distributed from the trust to a trust beneficiary before the annuitant dies.

Two General Types Of Annuities

Now let's apply these tax rules to the two general categories of annuities. Assuming it is prudent for the trust to own an annuity and that its purchase would not favor one beneficiary over any of the others, the trustee can further explore the risks and rewards of buying an annuity. At this point, the trustee should consider the two general types of annuities: immediate annuities and tax-deferred annuities.

(1) ***Immediate annuities*** make regular payments (usually annual) to the contract owner immediately after purchase. If the trust has an income beneficiary, an immediate annuity can be a good financial tool for paying annual income to the trust's income beneficiary. An example is a charitable remainder annuity trust (CRAT). The trust requires the trustee to pay 5% of the value of the trust's initial assets to the income beneficiary each year for life. The trustee is considering purchasing an immediate annuity to make the 5% annual payment.

In this case the immediate annuity could potentially help the income beneficiary in several ways. First the annuity will make the income payments for life—as long as the insurance company stays solvent, it will provide the money to pay the 5% income benefit. The trustee can concentrate on investing the other assets to grow for the remainder beneficiary. The fluctuation in assets' values over time will not negatively impact the ability to make the payments. Also, the trust will be able to shift income taxes on any growth in annuity values to the income beneficiary. A percentage of the payment to the beneficiary will be treated as taxable income but it will likely be taxable to the beneficiary, not to the trust. Since the beneficiary is very likely to be in a lower income tax bracket than the trust, this approach may be more income tax efficient.

(2) ***Tax-Deferred Annuities*** The second general type of annuity is tax-deferred annuities (TDAs). TDAs don't make payments immediately to their owners. Instead, the payments are deferred for a period of time. The value of a TDA usually grows each year during the deferral period because growth remains in the contract. It is not distributed until a future time when the annuity owner elects to annuitize the contract or requests that the insurance company pay out some of the contract's value in cash.

Income tax deferral can be quite valuable to trust beneficiaries because trusts reach the maximum 35% bracket when the trust's taxable income exceeds $11,650 (in 2012). In contrast, a natural person doesn't reach the maximum income tax bracket until his/her taxable income exceeds $388,350 (in 2012). Thus, if income taxes on the annuity's growth can be deferred until the time it is distributed to a living human beneficiary, significant income tax savings could potentially be realized.

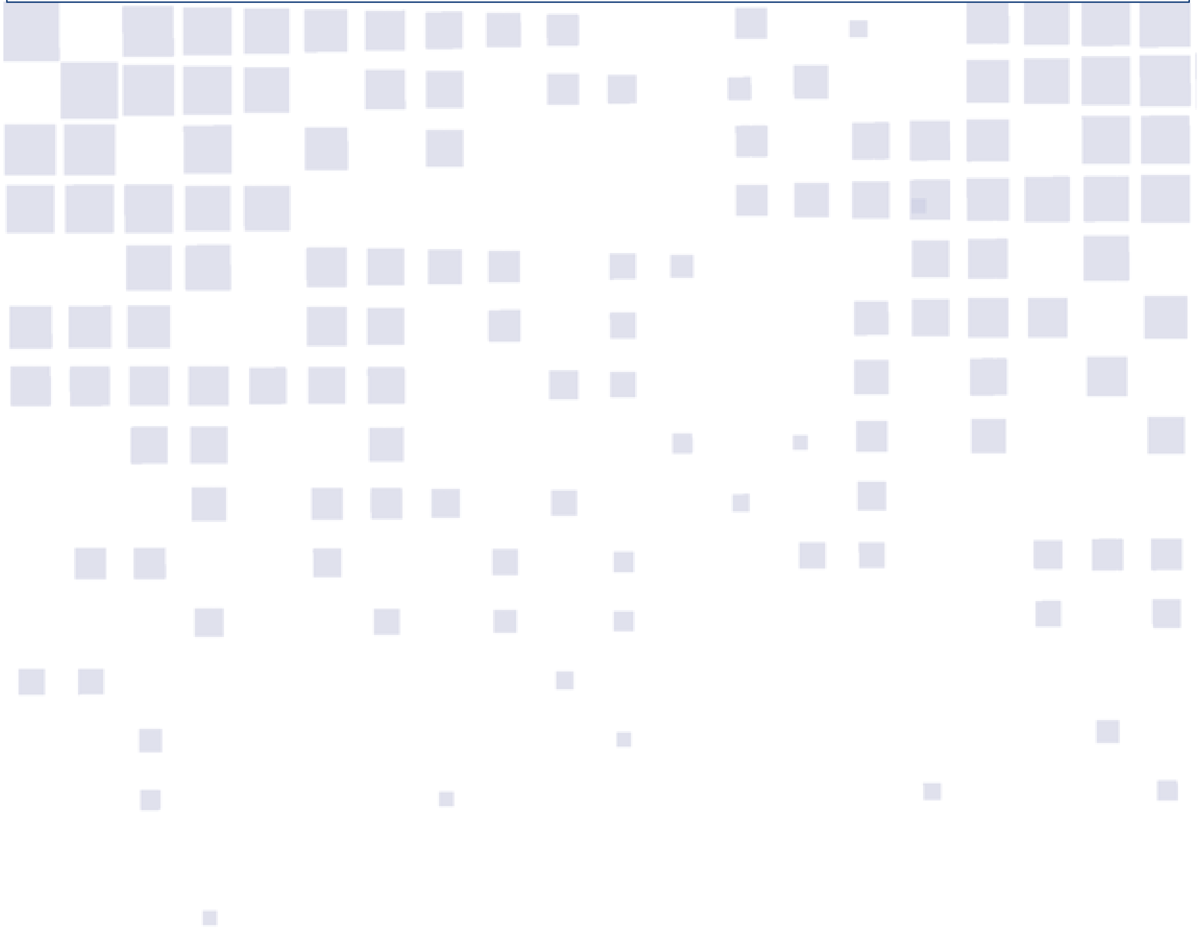
When Is A Trust Acting As An "Agent" For A Beneficiary?

However, in order to get income tax deferral, the trust must be deemed to own the TDA as an agent for a trust beneficiary. Because Section 72 doesn't explain what qualifies as an "agency relationship" and because the IRS has not issued any regulations on Section 72, it can be difficult to know when a trustee is acting as an agent for a trust beneficiary. To determine whether an agency relationship exists, it may help to ask several questions:

(1) ***Who is the annuitant?*** If a trust beneficiary is the annuitant, the likelihood of an agency relationship may increase, particularly if the trustee expects to distribute the annuity to this trust beneficiary in the future.

(2) ***If the trust has several beneficiaries or several classes of beneficiaries, has the trustee purchased separate annuities for each beneficiary in the class?*** If the trustee purchases a separate annuity for each beneficiary, the trustee may be more likely to be considered as an agent for them. If the trustee has purchased only one annuity to benefit multiple beneficiaries in a specific class, then it is probably less likely the trustee is acting as an agent.

(3) ***Is it likely the trustee will eventually distribute the annuity to a trust beneficiary?*** If the trustee is likely to distribute an annuity contract to a beneficiary rather than surrender it and distribute the proceeds, it may be more likely the trustee is acting as an agent.



A good source of information on how trust-owned annuities may be taxed in various situations comes from IRS private letter rulings (PLRs). Because there are no published regulations and few court cases, PLRs should be closely examined before a trustee purchases a non-qualified annuity. Keep in mind that PLRs apply only to the person who requested it and can't be used as precedent by anyone else. However, a PLR can indicate how the IRS views the tax issues addressed in the ruling. Here are some of the PLRs the IRS has issued on tax-deferred annuities owned by trusts:

- When the trustee's duties were limited to purchasing an annuity as directed by an individual and holding legal title to the annuity for his sole benefit and the trustee was not permitted to exercise any rights under the contract unless directed to do so by the individual, the trustee was deemed to be acting as that individual's agent.[3]

- When the trustee of an irrevocable trust purchased an annuity and had the power to select a settlement option or terminate the annuity contract, the annuity was considered to be owned by a natural person.[4]

- When a trustee purchased an annuity for the sole beneficiary of a trust and had the discretion to pay income and corpus to the beneficiary until age 40 at which time it was required to pay out the entire corpus (including the annuity contract), the trust was deemed to be an agent for the beneficiary.[5]

- When a trustee purchased an annuity contract for the sole benefit of the grantor's grandchild and was to distribute all trust assets (including the annuity) to the grandchild upon the trust's termination, the trust was deemed to be an agent for the beneficiary.[6]

[3] PLR 9639057
[4] PLR 199933033
[5] PLRs 9204010 and 9204014
[6] PLR 20049011

Specific Types of Trusts

It is difficult to make general statements about the income tax treatment of tax-deferred annuities in different types of trusts because the income tax results ultimately depend on many factors, including the specific terms of the trust. Clients and trustees should consult their tax and legal advisors for specific advice before a tax-deferred annuity is contributed to or purchased by a trust. With that in mind, here are some thoughts about non-qualified annuities being owned by specific types of trusts:

Revocable Trusts Because a revocable trust can usually be terminated by the grantor at any time with the trust assets being returned to the grantor, it is quite possible the trustee could be considered an "agent" for the beneficiary when the grantor is the annuitant. This probability is increased because the grantor is usually the trust's primary beneficiary while he/she is alive.

Grantor Trusts "Grantor trusts" are trusts in which the grantor has the responsibility of paying federal income taxes on income the trust earns. All the trust's taxable income is recognized and reported by the grantor, even though he/she may not be entitled to receive any of the trust's income or distributions of trust principal. There are many different varieties of grantor trusts and it is unlikely that grantor trust status, by itself, creates an agency relationship between the trust and its beneficiaries.

Grantor Retained Annuity Trusts (GRATs) In these trusts a grantor transfers property to a trust and retains the right to be paid a specified percentage of the trust's initial value (e.g. 5%) annually for a specified number of years. At the end of that time, the trust ends and the remaining assets are paid to the remainder beneficiary. Does it make sense for the trustee to purchase an immediate annuity to fund the grantor's income interest? It could if the cost of the annuity doesn't use up too many of the GRAT's assets. If the annuity costs too much, the trustee may be favoring the income beneficiary at the expense of the remainder beneficiaries. Even if the cost is reasonable, there may be a problem. If the GRAT is funded with assets valued at more than their cost basis, an immediate annuity may not be a good idea. The trustee would have to sell some of the assets in order to generate enough cash to purchase the annuity. The asset sales could trigger income or capital gains taxes that have to be paid by the grantor. The grantor might be unhappy with this increased tax burden.

Specific Types of Trusts (cont.)

Credit Shelter Trusts These trusts are generally designed to pass on to non-spouse family members the maximum federal estate tax free amount available at the time of an individual's death. If there is no surviving spouse, the trust assets may be divided into equal separate shares for the decedent's children. Depending on the circumstances, it may make sense for the trustee to purchase an annuity for each then-living child. However, if the individual's spouse survives, the credit shelter trust may be (and often is) designed to have two classes of beneficiaries. The surviving spouse may be the income beneficiary who is entitled to receive the entire annual income the trust investments produce. At the surviving spouse's death the remaining trust assets are distributed to the couple's surviving children in equal shares. In these situations the surviving spouse and children may have different interests. The spouse may want the trustee to maximize trust income while the children may want the trustee to maximize growth in the trust's assets.

Special Needs Trusts In these trusts the trustee is generally not required to make (and may actually be prohibited from making) distributions directly to the special needs beneficiary. Further, there are often other beneficiaries who may be entitled to receive the balance of the trust after the special needs beneficiary's interest ends. Because there may be multiple beneficiaries, the trustee may not be considered an "agent" if an annuity is purchased.

Charitable Remainder Trusts There are several varieties of charitable remainder trusts (CRTs). Whether the trust can own an annuity may depend on the type of CRT involved. The IRS recently ruled that a charitable remainder annuity trust (CRAT) could purchase an immediate annuity to pay part or all of the benefit payable to the income beneficiary.[7] For charitable remainder unitrusts (CRUTs) the result was different. The IRS ruled that an annuity was not an appropriate investment for the trust.[8] However, for a charitable remainder unitrust with a net income makeup provision (NIMCRUT), the IRS ruled that the trust could own a tax-deferred annuity without disqualifying the trust.[9]

Qualified Personal Residence Trusts (QPRTs) In general, trustees of QPRTs should not own annuities. QPRTs are specialized trusts that are limited in the assets they may own. Usually only residential real estate and cash are appropriate trust investments. The ownership of an annuity could potentially disqualify the trust as a QPRT and cause the gift tax benefits to be lost.

[7] PLR 201126007
[8] PLR 9009947
[9] TAM 9825001

CONCLUSION

Whether an immediate annuity or a deferred annuity is a suitable asset for a trust is not a simple question. The answer varies depending on: the type and terms of the trust, the ages and health of the beneficiaries, the asset management expertise of the trustee, the type of annuity, how any growth in the annuity will be taxed and the length of time the trust is likely to last. In the right circumstances, an annuity may be a useful asset for the trust; in the wrong circumstances, however, it can create several problems. When income tax deferral on any growth in the contract is important, the trust's tax / legal advisor should probably be consulted, because it can be difficult to know whether the trust will be considered to act as an agent for the trust's beneficiaries. Also, the trustee needs to be sure that in purchasing an annuity the trust will not be deemed to favor one beneficiary over another.

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