13 ways an annuity can benefit an estate plan

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NOVEMBER 19, 2013 • REPRINTS

A principal goal of many estate plans is to provide incometo the estate owner's heirs. This goal can often be achieved by using either **immediate or deferred annuities**. Where the goal is to provide heirs with an immediateincome, an immediate annuity may be the ideal mechanism, especially if the income is to continue for the recipient's lifetime. The certainty afforded by such a contract is sometimes more important than the amount of each income payment or the fact that the annuity income does not preserve principal. This may be particularly appropriate to satisfy specific beneficiary lifetime income bequests from a portion of assets while the remainder passes to another beneficiary.

Where the desire is for the heir's income to increase over time — perhaps to keep pace with inflation — an immediate annuity providing for known annual increases is often attractive. While most insurers do not offer immediate annuities with cost of livingincreases tied to some index such as the consumer price index, some do, and more are likely to be offering such contracts in the future in response to a demand that appears to be increasing. An additional attraction is that annuities enjoy creditor protection in most jurisdictions.

A disadvantage to immediate annuities, in this context and others, is their inflexibility. Most immediate annuities, once begun, do not permit modification of the payment amount or commutation, although an increasing number of contracts do.

Read on for 13 situations where an annuity can be the ideal estate planning tool.

1. Purchase of a single premium immediate annuity (SPIA) by a credit shelter trust

One application of immediate annuities which may be of interest to estate planners is their use to solve the trustee's investment dilemma. Often, a trust (e.g., a **credit shelter trust**) is established to provide both an income to an income beneficiary, perhaps the surviving spouse, and growth of principal, for the benefit of remainder beneficiaries, perhaps the children and/or grandchildren. The dilemma for the trustee is satisfying the opposing desires of these beneficiaries. The income beneficiary wishes to receive as much income as possible, and would prefer that trust monies be invested to provide that goal. Remainder beneficiaries are interested in capital accumulation, and prefer that the trust be funded with growth investments. The problem, of course, is that investments which provide high current income rarely offer good long term growth, and vice versa.

This conflict has always presented problems for trustees. A possible solution might be for the trust to purchase an immediate annuity, naming the income beneficiary as annuitant, in an amount sufficient to provide the income the beneficiary requires — perhaps increasing over time — and to invest all remaining trust assets solely for growth, without regard for whether they produce anycurrent income. Adverse results in the growth investments will have no effect upon the income beneficiary. This strategy does not always work, of course. Financially, its attractiveness may appear to be directly proportional to the age of the income beneficiary/annuitant, because, the older the annuitant, the greater the income that each dollar of premium will purchase; or, viewed another way, the less premium required to produce each dollar of income. This is assuming that the annuity is to continue for the annuitant's life. However, it's also arguable that older income beneficiaries are likely to die

sooner, and that an annuity which expires without value at the beneficiary's death may be perceived as a bad deal. The existence of a refund element may reduce this objection.

Whether a refund feature should be included in the annuity is, however, problematic. A life-only annuity will require a smaller premium than one providing a benefit to another beneficiary if the annuitant, or the income beneficiary of the trust, should die prematurely. This would allow a greater percentage of the trust corpus to be allocated to growth investments, for the benefit of remainder beneficiaries. However, many people, including many advisors, find an annuity that provides no further benefit if an annuitant dies shortly after income payments commence unacceptable. The perception is that the insurance company keeps this extra money. This perception is false; the money is notretained by the insurer, but is paid out by that insurer to other members of the risk sharing pool, or annuitants who lived longerthan their expected lifetimes. That said, the perception may be its own reality. Most people will not buy a life-only annuity and would probably prefer that such an annuity not be purchased for anyone of whom they might become remainder beneficiary.

2. Purchase of an immediate annuity for heirs outside a trust

Sometimes, an estate owner's goals include **providing a specific and certainincome for specified heirs**, apart from the overall dispositive provisions of the estate plan. Here, an immediate annuity is arguably the perfect instrument. Without the certainty of the annuity, a trustee or executor must take into account the market risk involved when invested assets must be accessed each year to make payments to the beneficiary. Thus, the use of an annuity may allow the trustee/executor to invest more money immediately on behalf of the other beneficiaries while still guaranteeing that the income beneficiary will receive all promised payments.

3. Purchase of a deferred annuity for heirs

Where estate planning goals include providing a certainincome for heirs to begin at some future time, a deferred annuity may make sense. Advantages include **tax deferral of current gains**, which can be of considerable importance if the annuity is owned by a trust subject to the compressed tax rates applicable to nongrantor trusts, creditor protection (to the extent allowed by relevant law) where the annuity is owned outside a trust, and the risk management and investment characteristics of deferred annuities discussed at length in earlier chapters of this book. Disadvantages include the overhead cost of the annuity, which may be higher than that of alternative investments, surrender charges (if applicable), the fact that all distributions from an annuity are taxed at ordinary income rates, and the unavailability of a step-up in basis for annuities owned by a decedent.

4. Purchase of a SPIA by the estate owner for the estate owner and spouse

Impact on the attractiveness of making lifetime gifts to heirs

A primary goal of many, if not all, estate owners is to ensure income for themselves for their lifetimes. This goal often surfaces in discussions between clients and advisors when considering lifetime gifts. "I might need that money" is perhaps the most common objection raised by many clients to suggestions that they utilize the gift tax annual exclusion in making lifetime gifts to heirs. To the extent that the estate owner is guaranteed that he or she — and his/her spouse, if applicable — can be assuredof required income no matter what, annual gifts to heirs, whatever the reason for making them, may be far less worrisome. If, having secured this required income, perhaps by purchasing an immediate annuity, a client feels able to make more lifetime gifts than he or she otherwise would, the result can be both greater net wealth transferred to heirs — due to **lower transfer tax** and estate clearance costs — and greater emotional satisfaction. One can live to see his heirs enjoy lifetime gifts. One can also see how well such gifts are managed. For the parent or grandparent concerned that sizeable inheritances might spoil the kids, being able to see how well those kids deal with the money can be both gratifying and informing. If the kids mishandle such gifts, estate plans can be changed, perhaps by adding additional spendthrift provisions.

Implications for the estate owner's asset allocation decisions

Even where lifetime gifts are not a concern, adequate income for the estate owner(s) is usually a key estate planning goal. "We want to provide for the kids and grandkids, but first we've got to take care of

ourselves" is a refrain familiar to all estate planners. Allocating a portion of one's retirement portfolio to an instrument designed specifically to produce income can help one achieve this key planning objective, to the extent of making the allocation of remaining assets easier, or at least, less worrisome. This can be done using either a deferred annuity or an immediate annuity.

5. Using a variable deferred annuity to provide death benefit to an uninsurable estate owner

A deferred annuity is **not life insurance.** A contract qualifying as life insurance under Section 7702 of the Internal Revenue Code has a death benefit that is taxed differently (under Section 101) from a contract qualifying as an annuity under Section 72. The two chief differences are:

1. All gain, or excess of contract value over adjusted basis, in an annuity will be taxed as Ordinary Income, either to the living contract holder or to the beneficiary. By contrast, the death benefit of a life insurance policy is generally received income tax free by the beneficiary.
2. Distributions to the living owner of a life insurance policy are generally taxed under a first in, first out basis. All distributions are considered a return of principal until all contract gain has been distributed. Distributions from an annuity (issued since 8/13/82) are taxed on a last in, first out basis, or as gain until all gain has been distributed. This same treatment also applies to life insurance policies that are modified endowment contracts.

That said, a **variabledeferred annuity** often provides a death benefit in excess of the contract's cash value, whereas the death benefit of most fixeddeferred annuities is limited to the cash value. The advantage of this additional death benefit in a variable annuity can be significant, especially for an individual who cannot obtain life insurance, or for whom the rates would be unacceptably high. This is for one simple reason: while the contract owner does not escape taxation on that death benefit, he or she does escape insurance underwriting. The annuity death benefit is available to anyone who is willing to pay the standard cost charged for it.
How large might that benefit be? Some variable annuities offer an enhanced death benefit that pays the greatest of:(a) the contract value at death; (b) total contributions, accumulated at a specified rate of interest (often, 6%) until a maximum age, which is sometimes, as late as age 91, this is often called the rollup value; or (c) the contract value as of the highest annual, monthly, or even daily, valuation date, prior to some maximum age.

If investment performance of the annuity is good, the resulting death benefit can be far greater than the amount invested, or the cash value otherwise available at the individual's death. Even if performance is poor, the second of those two factors produces a constantly rising floor under the contract death benefit.

Many advisors recommend variable annuities with strong enhanced death benefit guarantees for this reason. Yet even this strategy might be improved by splitting the annuity investment into more than one annuity contract, as can be seen from the following examples:

1. Ms. A invests $100,000 in a single variable deferred annuity with an enhanced death benefit. She selects a diversified asset allocation model, consisting of 50% equities and 50% bonds. At Ms. A's death six years later, the account balance at her death is larger than at any prior valuation date and is also larger than her contribution of $100,000, compounded at 6%—despite the fact that in the two years prior to her death, the stock market dropped significantly, while the bond market flourished. Her beneficiaries will receive the date-of-death account balance as a death benefit.

   That balance includes, not just the appreciated value of those subaccounts that did well (the bonds), but also the value of those equity subaccounts that lost money. The losses of the latter are netted against the gains of the former to produce the total account balance.

2. Mr. B splits his $100,000 into $50,000 contributions for each of two different variable deferred annuities, each with the same enhanced death benefit and also allocates his overall annuity holdings in a 50% equities/50% bond mix. He allocates all the equities to the first $50,000 annuity and all the bonds to the second. At his death, the account balance of the first

contract is lower than at a prior valuation date—due to the decline in the stock market—so that greater prior value is paid as a death benefit. The date-of-death balance of the second contract containing the bonds which did well, becomes the death benefit of the second contract.

The losses in the first contract are not netted against the gains in the second. Indeed, the losses in the first are ignored, because the rollup death benefit value is used. Thus, Mr. B's heirs receive more money at Mr. B's death, because they receive all of the appreciation from the contract holding bonds, and the rollup death benefit of the contract holding equities.

Sadly, many advisors are unaware of this strategy. Some even insist that an advisor's sale of two annuities instead of one is inherently bad. Often, this is because they believe it results in a higher commission, which it does not.

There is yet another reason why two deferred annuities can be better than one. This one works with both fixed and variable contracts and has nothing to do with death benefit.

Example: Ms. A invests $100,000 in a single deferred annuity. Two years later, she decides to withdraw $20,000 from the contract, which is now worth $120,000. Her entire withdrawal consists of gain and is, therefore, fully taxable. Had she bought two contracts, each for $50,000 and gotten the same investment results, she would now have two contracts of $60,000 each. She could withdraw the $20,000 from only one, whereupon only half ($10,000) of the withdrawal would be taxable as gain, with the other half being considered a return of principal. It is important to note that due to the annuity anti-abuse rules, all annuities purchased from the same insurance company in the same calendar year will be treated as one contract, requiring gains to be aggregated for withdrawal purposes. Consequently, a $20,000 withdrawal would still be treated as being withdrawn from an aggregate contract worth $120,000, resulting in the same $20,000 gain as the first scenario. Thus, to apply this strategy, the annuity purchaser would need to purchase each annuity from different insurance companies, or in different calendar years.

6. Using the guarantees in a deferred annuity to provide portfolio insurance

A **fixed deferred annuity** provides three guarantees to its owner:

1. A guarantee of principal. The money invested in a fixed deferred annuity is guaranteed against loss by the insurer.
2. A guaranteed minimumrate of return.
3. Guaranteed annuity payout factors.

The first two guarantees provide a known minimum return, on the portion of one's portfolio allocated to the annuity, which has the effect of lowering the overall principal and interest rate risks of the entire portfolio. Moreover, the assurance that this known future value can be converted into an income stream that will provide at least a certain amount of money each year can make projections of one's future cash flows less problematic.

A variable deferred annuity does not offer the first two guarantees to the living policy owner, except to the extent that annuity values are invested in the fixed account. However, it provides others. The guaranteed death benefit always provides assurance that heirs — not the living policy owner — will receive, at a minimum, the amount originally invested or the account balance at death, if greater. Enhanced death benefit guarantees, common in newer variable contracts, can assure heirs of the greater of that original investment or account balance at death or some other potentially higher minimum amount; perhaps the account balance at some policy anniversary prior to death or the original investment, compounded at some specified rate of return. If the minimum amount that will pass to heirs is a serious estate planning concern, the guaranteed death benefit may be worth its cost.

The guaranteed living benefits in today's variable deferred annuities may provide even more comfort for the estate owner in making his asset allocation decisions, precisely because of the refrain noted earlier, namely: "We want to provide for the kids and grandkids, but first we've got to take care of ourselves." The guaranteed minimum income benefit, guaranteed minimum withdrawal benefit,

guaranteed minimum accumulation benefit, and provisions combining all three features can assure the estate owner that, irrespective of the performance of the investments in the annuity, certain minimum income and/or future lump sum values will be available.

Many critics contend that the costs for these provisions outweigh the benefits that they are likely to provide. The mathematics supporting such a conclusion — if any are supplied — often rely upon historical averages and probable life expectancies. This is not to say that all such criticisms are invalid, or that the logic and mathematics are never valid or persuasive. They may be both. However, it is the authors' contention that the certainties these riders provide can be very important to many estate owner clients on an emotional level. These certainties, with regard to that part of a client's portfolio invested in annuities providing them, can enable the client to make asset allocations with regard to money that the client might not otherwise feel comfortable making. In addition, it's important to note that even though the client may come out with less money in the long run on average, the client is still guaranteeing that a particular minimum amount will be available, which may be more consistent with a client's goals than merely having the most dollars at death by investing heavily in equities.

Many clients, especially older ones, are often wary of putting too much in the stock market, even though they know that equities have historically provided significantly better returns than fixed dollar investments such as CDs and bonds. To the extent that such a conservative (read: risk-intolerant) client's equity investments can be held in an investment account which guarantees minimum future lump sum and present and future income values, the client may be willing to allocate more of his portfolio to such equities, and remain invested in them longer than if no such guarantees were available. For the client whose portfolio is not large enough to generate required income with reasonable certainty if invested very conservatively, this increased equity exposure might make the difference between an adequate income and just getting by, or even running out of money. Why might this be? The client might only be willing to invest substantially in equities if there are underlying guarantees, and would otherwise choose a much more conservative portfolio, with lower expected risk and return.

7. Using the guaranteed income of an immediate annuity to reduce retirement portfolio failure rate

As noted, the risk managementbenefits of either a fixed or variable deferred annuity may allow some clients to invest their **retirement portfolios** — the portion invested in those annuities, but also, perhaps, more of the nonannuity portion — more aggressively, and with more confidence, than they might in the absence of these guarantees. The result of such a change in allocation should, over time, be an increase in the income produced, despite the expenses of the annuity. For retirees living on less than the amount their portfolios earn, this translates to greater capital accumulation, ultimately providing more wealth to transfer to heirs.

Yet many retirees do not live on less than what their investments earn. For all too many clients, the most important issue is not how much will be left to heirs after they die, but whether their portfolios will produce enough for them to live on, for as long as they live. Indeed, this uncertainty represents what one of the authors refers to as the one big risk in retirement income planning, namely: "What are the chances that my account balance will fall to zero before my blood pressure does?". This risk can be managed, with considerable effectiveness, by use of immediate annuities. As was noted in the last chapter, there is mounting evidence that allocating a portion of one's retirement portfolio to a mechanism providing immediate, certain income can produce a significant increase in the probability that the portfolio as a whole will be able to provide required income for the retiree's entire lifetime, however long that may be. The purchase of a life annuity, either for a level or an increasing annual benefit, can offset — to an extent proportional to the percentage of required retirement income provided by the annuity — the effects of negative dollar cost averaging, where more shares must be liquidated to provide a set amount of income after a decline in the value of those shares than would have had to be sold if the share price remained level or increased. A life annuity is not the only way to implement this strategy. Laddered bonds or laddered period certain annuities may also be used. Whatever the implementation, this strategy can offset negative dollar cost averaging, decrease the probability that the retirement portfolio will be exhausted during retiree's lifetime — or produce declining income levels — and provide greater emotional comfort, although only an annuity guarantees that payments will continue even if an individual lives much longer than anticipated. In addition, this

strategy may foster greater willingness to make lifetime gifts to heirs and/or **gifts — lifetime, testamentary, or both — to charities.**

8. Using annuities to maintain tax deferral, and control, from beyond the grave

Ensuring tax deferral of gain beyond the annuity owner's lifetime

The income tax on annual gain in a deferred annuity is generally deferred until it is distributed. Distributees of annuity proceeds can benefit from even further tax deferral if those distributions are considered amounts received as an annuity. If so, a portion of each payment is excluded from tax as a return of principal under the regular annuity rules of IRC Section 72(b). This treatment applies to annuity payments whether made to an annuitant or to a beneficiary. Thus, if a deferred annuity is structured so as to ensure that the beneficiary or beneficiaries can, or perhaps must, take proceeds in the form of an annuity, the benefits of tax deferral will survive the annuity owner. This can be done utilizing a concept known as the stretch annuity.

What is a stretch annuity? In its broadest sense, one might say the term describes any annuity where the beneficiary designation allows, or requires the beneficiary to stretch death proceeds, and the benefits of tax deferral of undistributed gain, over as long a period as possible. Deferred annuity contracts nearly always allow the beneficiary to take proceeds in the form of an annuity, either over lifetime or for a period of years. If the beneficiary is the surviving spouse of the owner, he or she is typically granted a spousal continuation option, allowing an election to treat the contract as if it were his/her own from inception, and to name new beneficiary(ies), who will, themselves, be able to choose to take proceeds as an annuity. Moreover, many contacts permit the owner to ensurethat death proceeds will be eligible for the favorable tax treatment of the regular annuity rules by allowing the owner to require that death proceeds be taken by the beneficiary(ies) as an annuity.This election is usually made on the beneficiary designation form, or by election of a special contract option. Such election is usually revocable by the contract owner at any point before death, but not by the beneficiary after the owner dies.

However, election of a regular annuity payout option, whether by the owner or beneficiary, is not necessarily the only way to achieve this post-death tax deferral. The IRS has privately ruled that payment of annuity death benefits to a beneficiary where the amount of each payment is determined by the life expectancy fraction method, rather than by the payout factors of a regular annuity option, can satisfy the requirements of IRC Section 72(s). The undistributed gain would not be constructively received (and would, therefore, enjoy tax deferral until it is distributed). In other words, the private ruling allowed a beneficiary to take systematic withdrawals as the beneficiary of an annuity, without annuitizing, and still stretch the payments — and tax on the gain — over the beneficiary's lifetime.

In a subsequent letter ruling the IRS went even further, to hold that, under certain circumstances, payout to a beneficiary using this method or the amortization or annuity factor methods will qualify as amounts received as an annuity. As such, the regular annuity rules of IRC Section 72(b) would be applicable, whereby a portion of each annuity payment is excluded from tax as a return of principal. It must be noted that the ruling which permitted this tax result did so on the basis of case-specific facts. Advisors should not assume that this result is available for any particular client without a ruling from the Internal Revenue Service. Moreover, many annuity contracts do not permit the life expectancy fraction method to be used. Finally, insurers that do permit this option may issue a Form 1099-R to beneficiaries indicating that the payments made are amounts not received as an annuity. That is, they may not apply the regular annuity rules exclusion ratio, but will report such payments as fully taxable, to the extent of any remaining gain in the contract.

Of the three optional methods referred to previously (amortization, annuity factor, and life expectancy fraction), the last offers the most stretch of tax deferral, because it permits smaller payments in the early payout years. It also offers beneficiaries the greatest flexibility. Most annuitizations are irrevocable. The beneficiary is stuck with the arrangement for the duration of the payout, which may be for that beneficiary's entire lifetime.

By contrast, the fractional method permits the beneficiary to take only the relatively small amounts required under that method and the freedom to take amounts over and above those required at any

time. Moreover, undistributed proceeds will remain invested in the chosen subaccounts and any gains earned will continue to enjoy the benefit of tax deferral.

As noted, the life expectancy fraction method of payout offers the most stretch. Thus, a more restrictive — but, in the authors' opinion, better — definition of stretch annuity is any annuity contract that guarantees for the beneficiaries the right to take proceeds according to this life expectancy fraction method. This definition might be refined even further, to include only contracts that waive surrender charges upon death.

A few caveats should be noted. First, as was noted above, not all deferred annuity contracts allow the beneficiary to use the life expectancy fraction method or, for that matter, the other two optional methods described in Notice 89-25. Many, especially older contracts, restrict the beneficiary to the use of regular annuity options. Second, not all contracts that do make the life expectancy fraction method payout arrangement available to beneficiaries permit the policy owner to restrict beneficiaries to using only that option. But is that necessarily a bad thing?

An annuity owner's right to restrict beneficiaries to some form of stretched payout of death proceeds does offer the benefit of post-death tax deferral. But it does so at the cost of flexibility. What if the beneficiary has extraordinary, unanticipated financial needs such as uninsured medical bills? An irrevocable annuity income will be of little help in meeting such expenses.

Some flexibility and post-death control may be offered by the use of special beneficiary designations or contractual options. One key benefit of these is that annuity owners can place certain limitations on how beneficiaries receive the money after death, without having to go through the cost and trouble of having a lawyer draft a trust to accomplish that goal. Of course, it should be noted that **a trust can provide much greater flexibility to accomplish goals** than use of a beneficiary designation, which, no matter how special, cannot.

However, a nonqualified annuity payable to a trust will be required to make a full distribution under the 5-year rule (as discussed in Chapter 2), while the same annuity payable to an individual beneficiary with a restricted beneficiary designation may provide for similar restrictions while still allowing the beneficiary to stretch withdrawals and income tax consequences over his/her lifetime. Consequently, as long as trusts cannot be designated beneficiaries, owners and their advisors must weigh the income tax consequences with the flexibility allowed by trusts in determining an appropriate course of action.

Example: One major insurer offers a Predetermined Beneficiary Payout Option that permits the owner to restrict the beneficiary to a payout over his/her lifetime calculated only in accordance with the Single Life table of Treasury Regulation Section 1.401(a)(9)-9, Q&A 1, and, upon reaching a specified age, access to any distributions above the minimum specified by that table.

However, some deferred annuities do not offer such provisions. It is essential that the advisor know what stretch provisions are permitted by the annuity contract being considered. Whether the law permits a payout option is a moot point if the issuing insurer does not offer it. It is also crucial that the advisor knows whose death will result in the payment of the contractually guaranteed death benefit of the annuity being considered. In annuitant-driven contracts, the death of a nonannuitant owner will force distribution (per the requirements of IRC Section 72(s)), but any guaranteed death benefit exceeding the cash value in the contract will not be payable.

9. Using a SPIA to provide for a longtime household employee

Often, wealthy clients wish to provide benefits, at their deaths, to longtime household help. They may be concerned that the employee might lack the skills to manage a lump sum bequest, or might squander it. A direction, in the estate planning documents, to purchase an immediate annuity for the benefit of that employee can address these concerns, without the hassle of establishing a standalone subtrust for such purposes. A **SPIA** would ensure an income for that employee for lifetime; moreover, the cost of a life-contingent immediate annuity for a specified amount of income decreases with the age of the annuitant at issue. Thus, the longer the estate owner lives, the older the employee will be when the annuity is purchased, and the lower the cost of the annuity.

10. Using a SPIA to fund a small bequest

Similarly, a SPIA might be used to fund a small bequest to someone not a beneficiary under the client's trusts, where there is concern that the recipient might be unable or unwilling to manage the bequest prudently and where the amount of the bequest is less than the minimum that professional trust managers will accept. Of course, this assumes that the SPIA bequest itself would still produce a large enough monthly or annual payment to be a meaningful bequest in the eyes of the decedent.

11. Purchase of a SPIA by a trust for the benefit of children not his and hers

As Mancini, Olsen, & Warshaw note, "When a trust is created at the death of an individual for the benefit of his or her spouse and children, if the children are not also the surviving spouse's children, tension can develop over the trust's investments." One solution might be for the trustee to be directed to purchase one or more immediate annuities for the benefit of that deceased spouse's children and manage the balance for the benefit of the other trust beneficiaries. Of course, this does separate out the trust principal at the time of first death, making such principal, and its interest, unavailable to the surviving spouse while he/she is still alive, but it avoids the cost of drafting multiple trusts to accommodate all the heirs.

12. Using a deferred annuity to fund a QTIP trust

In some estate planning situations involving trusts, the use of an annuity may be problematic. Gary Underwood writes:

"Annuities may not be appropriate investments for **QTIP trusts** for a reason associated with state law definitions of income. In most states, the undistributed gains inside of an annuity are not defined as income, and therefore may not have to be distributed to the income beneficiary. Income would only be recognized to the extent the trustee made withdrawals of gains from the annuity. If the trustee made no withdrawals, then there may be significantly less trust income to distribute to the surviving spouse. The trustee could be placed in an unenviable position between the surviving spouse who may want to maximize income and the children who want to maximize principal for later distribution. Unless the trustee and all beneficiaries agree on specific parameters for any annuity withdrawals, an annuity may present problems."

Some of the aforementioned problems highlighted by Underwood can be mitigated by a clear drafting of the QTIP trust before the first death (i.e., to clearly state what constitutes income and whether/how income with respect to the annuity will be classified for income distribution purposes). In some cases, the treatment of an annuity may be preferable to alternatives, if the specific goal is actually to minimize income distributions to the surviving spouse. On the other hand, if the spouse is not happy with such an arrangement, the spouse could potentially have the annuity liquidated, under the required right of a spouse under a QTIP trust, compeling the trustee to convert QTIP assets to income-producing property. If such a conversion occurs after many years, the trust could be compelled to recognize significant accrued taxable gains in a single year. Accordingly, it may ultimately be wise to avoid the use of deferred annuities inside of a QTIP trust, unless the spouse income beneficiary is clearly supportive of the arrangement, and unlikely to have his/her mind changed.

13. Using a variable annuity to fund a charitable remainder unitrust

One commonly used application of a variable annuity is in funding a **charitable remainder unitrust (CRUT)**. In fact, the variable annuity has often been touted as the perfect funding instrument for the so-called spigot NIMCRUT — especially by those marketing variable annuities. Is it? The following discussion will examine the pros and cons of such a strategy. But first, some terms need to be defined. What is a spigot NIMCRUT?

A CRUT is a type of Charitable Remainder Trust (CRT) — a split-interest trust with a charitable remainder beneficiary and one or more noncharitable beneficiaries with rights to payments each year

during the term of the trust. Often, the estate-owner client is the noncharitable beneficiary. The CRUT provides that the noncharitable beneficiaries will receive a unitrust amount each year (i.e., a certain percentage of the trust value, as revalued each year). CRTs that pay specified amounts each year are called Charitable Remainder Annuity Trusts.

The NIM stands for Net Income with Makeup. Net income means that each year the trust will pay the lesser of the net income or the payout percentage specified in the trust to the noncharitable beneficiary. The makeup part means that whenever net income is less than the payout percentage, the shortfall is credited to a makeup account, which can be tapped later on if the trust's net income exceeds the specified payout percentage, but only to the extent of that excess.

The spigot part means that the payment stream can be turned on and off, as with a spigot. Typically, this works by having a special independent trustee instruct the trust administrator to turn the payment stream on or off, as needed by the noncharitable beneficiary.

Proponents of the variable annuity-funded spigot NIMCRUT sometimes assert that only with a variable annuity can the noncharitable beneficiary be sure of being able to tap the makeup account, which may have been created deliberately by having the trust invest in the early years in vehicles which produce only capital gains, but no trust income.

This is not necessarily true. First, the Principal and Income Act of the state in which the trust is sited may permit allocation of post-contribution capital gains as either income or principal, each year, as the trustee sees fit. Secondly, there are certain types of investments that can produce income on demand, so to speak, such as a Limited Liability Company (LLC). Some commentators have described a one person LLC as the ideal spigot NIMCRUT instrument, where state law permits such entities.

There are also some fundamental disadvantages to using variable annuities to fund this type of CRT. First, there's the fact that, beneficiaries of a CRT are generally taxed under a four-tier system in which trust income is deemed to be (1) ordinary income, (2) realized capital gains, (3) tax-exempt income, or (4) principal, in Worst In, First Out (WIFO) order. All distributions from an annuity are always ordinary income. A CRT funded with an annuity can never receive capital gains treatment on any gains from that annuity.

A second disadvantage is that a variable annuity owned by a NIMCRUT is not considered to be owned as an agent for a natural person. Consequently, annual gain in the annuity — even if not distributed — is taxable. Although the NIMCRUT itself is a tax-deferred entity, insurance companies have recently adopted the practice of issuing a Form 1099-R to the CRT/owner, showing the annuity gain to be currently taxable. Previously, many insurers did not issue a Form 1099-R to report undistributed gain if the contract owner was a CRT, since it is already a tax-exempt entity. For this reason, and because charitable trust accounting is very complex, advisors recommending or considering a variable annuity to fund a NIMCRUT should be aware that the services of an accountant experienced in charitable trust accounting will be essential.

A third disadvantage is the wrapper cost of the annuity, which was discussed earlier. These overhead costs can serve as a drag on investment performance, especially if the insurance charges produce benefits only for the charitable remainder beneficiary and if the client's interest in benefiting the charity is secondary. It should be mentioned, here, that the first word in the term charitable remainder trust is charitable, and that advisors and clients probably ought to keep that in mind.

Critics of using variable annuities to fund spigot NIMCRUTs often harp on these disadvantages, often without acknowledging that there might be advantages in the bargain. This is neither fair nor accurate.

Ordinary trust accounting rules treat realized capital gains as additions to trust corpus, not as income. However, a CRT can be drafted so as to allow the trustee to treat capital gains as income**.** Regardless of which rule is applicable, if the trust investments include, say, a stock which has appreciated in value in the trust, but which is now performing poorly, the trustee, or a special trustee, of a spigot NIMCRUT may have an unpleasant decision to make if the income beneficiary doesn't happen to want income at the time. If the stock is sold, the gains are additions to principal, which will not benefit the income beneficiary; or, the trustee treats the capital gain as income**,** but at a time when the beneficiary doesn't want income.

On the other hand, a spigot NIMCRUT funded by an annuity can be drafted so as to define distributable income as any distribution from the annuity used to fund the trust, provided state law permits such language. Buys and sells within the annuity aren't income unless actually distributed. When income is desired, the distribution may be taken in the amount desired — limited, of course, by the actual gain the annuity has produced — provided that there is gain in the annuity. There can be no distributable income from the annuity unless its value exceeds its basis (the amount originally invested). If no gain exists in the annuity, no income exists to be distributed to the income beneficiary, because of how trust accounting rules define income. This last point is all too often not fully understood by clients, or advisors.

It's also important to understand that when a spigot NIMCRUT defines distributable income, that definition of income — or the definition under the state's Principal and Income Act — may be different than taxable income earned by the trust. This is specifically applicable when a NIMCRUT owns a variable annuity, because the trust's nonnatural person ownership causes annual gains on the contract to be taxable. Consequently, even when a NIMCRUT receives a Form 1099-R for taxable income attributable to annual gains on the contract, it does not necessarily mean that the trust must distribute that amount of income under its net income requirements, if the definition of income states otherwise.

The bottom line answer to the question of whether a variable annuity is the best funding instrument for a spigot NIMCRUT or not is, as one might expect, it depends on several factors. These include: what the client's state Principal and Income Act permits, how flexible a spigot the client requires, and the size of the annuity wrapper costs, just to name three factors.