Making Estate Lemonade With Annuity Lemons

By Patrick H. Yanke, CFP®

While annuities are often maligned, you may have bought one to fill a need in your financial plan. The purpose of an annuity is found in its definition – it's an income stream insured to last for a contracted period. Many people have annuities to meet the retirement challenge of not outliving their savings. These contracts may be a valuable complement to Social Security and pension plans.

Annuities also have defects. They involve high taxes, inefficiency, no step-up of cost-basis (which can increase the tax liability for heirs) and are generally expensive. There are products on the market that solve most of these problems while providing financial planning solutions for investors.

The problem with traditional annuities is that all gains in annuity contracts are removed first and taxed as ordinary income (last-in, first-out LIFO). That makes it hard for owners and heirs to recover principle as they may have a great deal of taxable income to receive before realizing a tax-free return of premium.

There is one scenario where the LIFO equation turns back to FIFO (first-in, first-out) – when the contract is annuitized. Unfortunately for estate considerations, the normal rule of annuitized contracts is that there is no death benefit for the heirs. When activated, an annuitized contract simply pays income to the owner until the end of the contracted period. All principle is surrendered to the insurance company in exchange for income payments.

A Better Solution

There is a product on the market that allows annuitization while still allowing the contract owner to maintain control of the investment. Principle remaining at the end of life is available as a death benefit for the heirs. This means that the current owner of a contract may enjoy tax-advantaged income (due to the annuity exclusion ratio) during the remaining lifetime and pass on what remains in the contract to heirs. The heirs have the ability to reach into the contract to pull out the principle tax-free and stretch out the gains over their lifetimes to control their annual tax bill.

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Who would benefit from this strategy? Consider the investor who took advantage of reduced capital gains in the Fiscal Crisis of 2008 and shifted a portion of the investment portfolio to annuities for the tax-deferral benefit. There may be significant gains in the contract now. Those gains have become a liability to the owner and the heirs. A tax-free 1035 exchange to a product which provides both tax-advantaged income for the remainder of retirement and better withdrawal options for the heirs may solve this problem.

The Long-Term Care Question

The long-term care (LTC) insurance market is changing rapidly. Insurance companies have found that there truly is a 50 percent chance of a claim beyond age 65! Given that insurance contracts must be aleatory (there must be an element of chance), how do you adequately price an insurance contract for a near-certain claim?

Many major insurance carriers have left the LTC insurance business. Those that remain have significantly increased premiums and reduced benefits. The insurance landscape is evolving to meet the needs of the marketplace.

Many people are now finding value in asset-based insurance contracts that include a long-term care rider. Rather than the traditional model of paying a high annual premium throughout retirement to keep the insurance in force, the hybrid annuity contract becomes an asset to be used for any financial purpose. As an annuity, the contract may provide income to the annuitant or pass the remaining contract value to heirs. Those options are not available in traditional, pay-as-you-go insurance contracts.

Consider the investment made in an annuity years ago. After many years, there is likely a low cost-basis. Nearly every dollar removed will be realized as taxable income, even if the contract is annuitized – there isn't much of an exclusion ratio in that scenario. If the contract is exchanged to an eligible hybrid contract, the amount available for long-term care may increase (as much as three times in some cases!) and the LTC benefit will be tax free! What was once a tax liability may become an important part of the financial plan.

In both of these scenarios involving estate and long-term care, the annuity solutions are only for taxable contracts. Contracts held in a retirement plan or IRA will be taxed in accordance with the nature of the retirement account.

There are new ways to realize annuity benefits you may have never considered – using a tax-inefficient product in tax-efficient ways.

This article did not get into product specifics due to regulation of the financial services industry. Specific questions on financial instruments will be answered by direct request.

Patrick Yanke is a financial planner whose business philosophy is simple ... treat others as he wants to be treated. Not bound by the limits of geography in an age of technology, he has clients in every American time zone. Since people make better decisions with better information, he keeps his clients informed through personal contact, newsletters and speaking programs. He presents often on a full range of financial topics. His best relationships come from solving problems for people. Patrick sits on the industry advisory panel for the American Public University System. Visit www.yankefinancial.com for more information.