



LEVERAGING TAX-DEFERRED ANNUITIES IN IRREVOCABLE TRUSTS

**For an audience with a basic understanding of the financial industry.
Not intended for use with the general public.**

Not FDIC/NCUA insured • May lose value • Not bank/ CU guaranteed • Not a deposit • Not insured by any federal agency



While some financial planning clients need to only focus on sustaining themselves throughout retirement, others have more long-term needs that can require significant strategic planning.

Efficiently transferring assets to the next generation – or even two or three generations – is a complicated task. It is made more so by the potential bite of state and federal estate taxes. In 2020, the federal estate tax of 40% applies to any estate over \$11.58 million per individual and \$23.16 million per married couple.ⁱ For more modest estates, having assets appropriately titled in vehicles that help to avoid a costly public probate process can save time and money, as well as keep details of the estate private. Exploring planning options to avoid those taxes, transactional costs, and fees is well worth the time and effort.

One of the strategies utilized in multi-generational estate plans are trusts, a proven planning tool to protect assets from transfer taxes while also providing creditor protections for the beneficiaries. Often, in order to minimize tax payments, a tax-controlled investment such as life insurance is often placed in an irrevocable trust. An Irrevocable Life Insurance Trust (ILIT), funded by a client, allows that client to purchase an insurance policy outside of their estate, replacing the assets that may be required for payment of estate taxes upon their death. However, there is no upside potential to a life insurance policy's investment cost. Given the uncertainty around planning for future estate tax and probate issues, it is well worth looking for other potential avenues that can still provide tax-controlled investments for clients who see transfer tax avoidance as a priority.

Non-grantor trusts have their own tax identification numbers, and so once assets are transferred to such a trust, they are no longer considered part of the grantor's estate. They also have their own trustee(s), a person other than the grantor of

2020 TRUST TAX RATESⁱ

10%	\$0 - \$2,600
24%	\$2,601 - \$9,450
35%	\$9,451 - \$12,950
37%	\$12,951 +

i. IRS Rev. Proc. 2019-44. IRS Announces Higher Estate and Gift Tax Limits for 2020, Forbes.com, Nov. 6, 2019.

the assets, who is trusted to oversee the management and distribution of the account. A trustee can be a family member, a friend, or a third party, such as a bank, law firm, trust company, or financial advisor who specializes in managing trusts and estates.

Naturally, the federal tax code is set up to discourage an accumulation of significant assets outside of a person's taxable estate. Trust tax rates are prohibitively high, hitting a maximum of 40.8% (including the 3.8% Net Investment Income Tax mandated in the Affordable Care Act) at just \$12,950 of income per year.ⁱⁱ There is essentially only one method to lessen this burdensome tax – to distribute the trust earnings to the beneficiaries on a yearly basis so that they may pay the taxes at their individual tax rates. This is such a common occurrence that there is even a rule that allows for excess distributions from the prior year to be made up to 65 days into the following fiscal year. However, this only creates a new dilemma: How is the client being served if the assets put into an irrevocable trust, in order to remove the assets from their taxable estate, are being returned to that estate through yearly distributions?ⁱⁱⁱ In addition, courts are increasingly limiting the creditor protections for discretionary beneficiaries of these trusts, which should make any trustee of a complex/spendthrift trust think twice about making discretionary distributions.^{iv}

The consequences of positive earnings within many non-grantor trusts – such as Generation Skipping Trusts (GSTs) and Dynasty Trusts – is that any choice concerning the handling of these earnings is detrimental to the trust itself. Using the trust to pay taxes depletes the growth in the trust significantly. If the earnings are distributed in order for the beneficiary to pay the taxes at a lower individual tax rate, it can raise the beneficiary's

income, potentially moving them to a higher tax bracket. The beneficiary is within their rights to request additional funds from the trust to pay the higher taxes, which can create a vicious cycle that results in assets leaving the trust. Ultimately, the benefits of an irrevocable trust are greatly diminished in any of these scenarios.

Trustees are also being forced to grapple with evolving markets, and volatility has increased due to these changing markets. Governments buying up debt or printing more money has increased volatility in the economy as well. This can lead to portfolio management issues as changing markets cause managers to reassess their market exposures. These issues can culminate in short-term capital gains which are taxed as ordinary income, adding to the repercussions of the problems discussed previously. The advent of the 24-hour news cycle has led to markets becoming more highly correlated as well.^v Understandably, trustees have begun to look into alternatives, such as stocks and bonds, to better diversify their portfolios. However, any taxable account could run into the same distribution issue, draining trust assets slowly but surely.

Trustees therefore find themselves between a rock and a hard place. They are duty bound to both protect the assets in their care for the income beneficiary of the trust and grow the trust corpus for the benefit of the remainder beneficiaries. In order to represent all types of beneficiaries equitably, the trust must grow at a rate that exceeds inflation, in addition to the trust's taxes and fees.^{vi}

The 1994 Uniform Prudent Investor Act (UPIA) advocates for trustees to use Modern Portfolio Theory and a total return investing approach.^{vii} Follow-up legislation, the 1997 Uniform

ii. Tax Cuts and Jobs Act, 2017.

iii. IRS Code § 1.663 (b)-1 Distributions in first 65 days of taxable year.

iv. Blech v. Blech, State of California, 2019

v. Merve Alanyali, Helen Susannah Moat and Tobias Preis, "Quantifying the Relationship Between Financial News and the Stock Market," Scientific Reports ISSN 2045-2322 (online), Macmillan Publishers Limited, 2017.

vi. Robert J. Aalberts and Percy S. Poon, "The New Prudent Investor Rule and the Modern Portfolio Theory: a New Direction for Fiduciaries, American Business Law Journal," Fall 1996

vii. Edward A. Moses, J. Clay Singleton, Stewart A. Marshall III, ACTEC Journal 2004, "Modern Portfolio Theory and Prudent Investor Act."



Principal and Income Act (UPAIA), indicates that adding capital gains to trust principal is a rule to which trustees should default (Sec 404) in order to see the trust grow at an inflation-adjusted rate with the remainder beneficiaries in mind. The UPAIA also allows for trustees to accommodate discretionary distributions by changing principal, which is made up of capital gains, to income (Sec 104) by allowing capital gains to be used as Distributable Net Income (DNI). Diversified portfolio management became easier as a result, since trustees would not have to hold bonds and dividend paying stocks as a source of DNI.^{viii}

While this may seem like a necessary bit of flexibility within a managed portfolio, it can also introduce more confusion relating to taxation on realized capital gains. Should the tax be paid by the trust when recognizing the capital gains or should the tax burden shift to the beneficiary receiving the distribution, and therefore be taxed at a new rate? The 2004 IRS Section 643 does not make it clear, because while the tax code refers to capital gains, interest, and dividends, the UPAIA references “principal” and “income”.^{ix} Without a clear answer, many feel the default rule applies and that the distributed capital gains should be paid by the trust. The result is higher capital gains taxes via the tighter trust tax brackets, which can require more capital gains to be dispensed in order to cover the tax payment distribution. It goes without saying that this inhibits the potential growth within the trust corpus.

Another troublesome detail for the trustee is that they have a fiduciary responsibility to both protect trust assets and, at the same time, create growth in the trust. But none of the aforementioned sources discuss how the impact of taxation upon the trust’s growth figures into their fiduciary responsibilities. Is marginal growth within the portfolio, due

viii. National Conference of Commissioners on Uniform State Laws, “Uniform Principal and Income Act,” last revision 2008.

ix. ix. John Goldsburly, “Dealing with the 23.8% Tax on Trust Capital Gains: 21 Ways (and Counting) to Have a Trust’s Capital Gain Taxed to the Beneficiary,” 2014.



to a taxation of distributions, grounds for the remainder beneficiaries to find legal fault with the trustee's portfolio management? There is currently no clear answer in any of the relevant trust documentation.

To summarize – if the taxes are paid with the trust, the taxation rate will be much higher than an individual's tax rate. If the earnings are passed to the individual, it adds to that individual's annual tax burden as well as their overall taxable estate, negating the very reason for the trust's existence. In either eventuality, the impact of the careful planning done by the client and their advisor is minimized. Taxation, and the troublesome manner in which it touches each aspect of an irrevocable trust, is one reason to explore alternatives to taxable and agency accounts for funding these vehicles.

Similar to the market evolution discussed earlier, tax-deferred* annuities (TDA) have also evolved over time. Traditionally, one thinks of a TDA as a vehicle to deliver a guaranteed stream of income over time. Often the costs associated with that income

guarantee, as well as the associated surrender schedules, fees, and the commissions recouped by those who sold them, made them unattractive from a cost perspective. TDAs previously had limited investment options as a means to mitigate the risk to the insurance carrier. And from a tax perspective, they were not attractive for a trust investment because earnings were taxed as income, not at the lower capital gains rate. Also, distributing a TDA from a trust would change its ownership and force a taxable event with no accompanying step-up in basis for the new owner. Luckily, much of this has changed over time.

Today's TDA, also known as an Investment Only Variable Annuity (IOVA), is offered as an investment platform by insurance companies, with a la carte sub-account management capabilities from reputable firms. There is no longer a guaranteed income stream from a TDA. The fees and costs associated with that guaranteed income are gone, as is the commission fee. Beyond these differences, IOVAs also have several characteristics that may make them ideal for a trust investment specifically. If initially titled correctly within the trust,

*Tax deferral offers no additional value if an annuity is used to fund a qualified plan, such as a 401(k) or IRA. It also may not be available if the annuity is owned by a legal entity such as a corporation or certain types of trusts.

the IOVA can pass in kind to the remainder beneficiaries, which would allow the tax deferred growth to continue uninterrupted. There are no annual required distributions which allows all growth within the IOVA to grow tax-deferred until retirement distributions begin. If a beneficiary requests earnings to be distributed, the trust would do so via a K-1 (IRS form 1041). This allows for the earnings to be taxed at the individual's marginal tax rate, which is often lower than an individual's capital gains rate. Take the following hypothetical example:

A couple with two college-aged children has earned income of \$165,000 and \$10,000 in long-term capital gains in one year. Combined, this puts them in the 22% tax bracket. After subtracting their standard deduction of \$24,800, they have net taxable income of \$150,200, which is still within the 22% bracket. However, with a progressive tax system, the first \$19,750 of income is taxed at just the 10% rate and the next \$60,500 is taxed at the 12% rate, leaving the remaining roughly

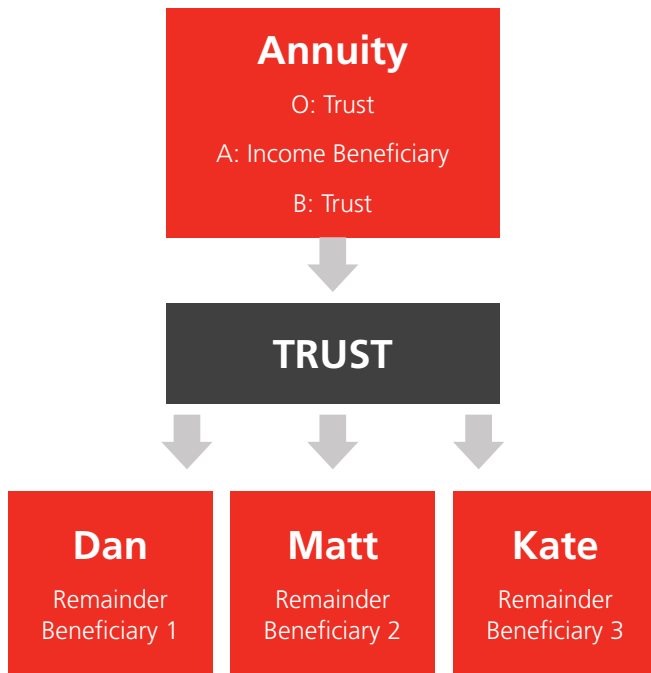
\$70,000 to be taxed at the full 22%. When you take this into account, the overall rate of taxation is actually 14%, which is significantly lower than the couples capital gains tax rate.

It is important to note that earnings in a TDA are considered "pension and annuity" income. A distribution to a beneficiary under the age of 59 1/2 years would be subject to an additional 10% excise tax [IRC Section 72(q)]. This is a characteristic to keep in mind when deciding if this strategy will work as part of a client's overall financial plan.

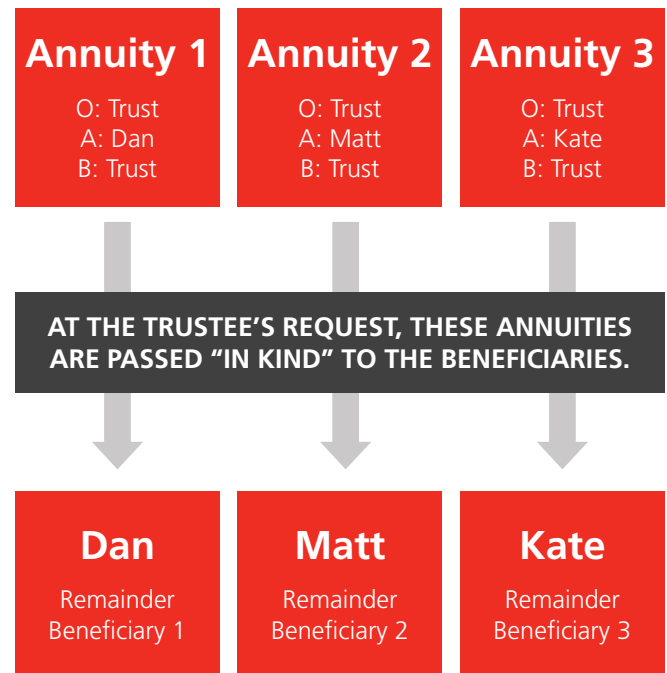
This chart illustrates a \$12.5 million GST portfolio with a gross return of 8%, which equates to \$1 million. The Trust with Distributions column represents the trust with a taxable or agency account within it, while the Trust with Tax-Deferred Annuity column represents the trust with the IOVA. The obvious effect is that while the IOVA maintains the 8% return because the capital gains, interest, and dividends are retained

\$12.5 million Generation-Skipping Trust Portfolio	Trust with Distributions	Trust with Tax-Deferred Annuity
8% Portfolio Gross Return	\$1 million	\$1 million
Cash Outflows:		
Capital Gains	\$700,000 received. Trust pays \$235,200 in tax.	\$0
Interest	\$100,000 (paid to beneficiary, who pays \$45,200 in tax)	\$0
Dividends	\$200,000 (paid to beneficiary, who pays \$66,400 in tax)	\$0
Net Portfolio Growth	\$464,800	\$1 million
Total Taxes Paid	\$346,800 total taxes paid (\$111,600 paid by beneficiary)	\$0
Portfolio After Tax Return	5.23% total net growth (3.72% in trust + 1.51% to beneficiary)	8%

“Standard” Titling



“Pass-in-kind” Titling



and not taxed. Instead, all three are taxed at the trust's or the beneficiary's tax rates in a taxable account, resulting in a significant loss of growth to the trust. Worse than just losing growth in the trust, the distributions add significant wealth back into the taxable estate of the beneficiary. The primary reason to create a GST is to skip the next generation because their taxable estate is already an issue. Distributions to that generation compounds an already-known problem. Given the potential longevity of the GST trust, it could make sense to utilize a vehicle that can continue to build value as it passes to multiple generations.

The most common non-grantor trust is also known by the names B-trust, Bypass trust, or Credit Shelter Trust. When the trust is funded, the goal is to leave the assets in the trust to grow for the remainder beneficiary's benefit. However, retaining the earnings in the trust to avoid estate taxes is pointless if the trust taxes drain the growth at a similar rate on a yearly basis. No matter which option is chosen, the value of the trust

planning is diminished. A trust which purchases an IOVA and names the three remainder beneficiaries the annuitants can grow tax-deferred for the life of the income beneficiary. If and when the income beneficiary needs a distribution, one can be made and would be taxed at the beneficiary's marginal tax rate. Upon the income beneficiary's death, the remainder beneficiaries each receive an IOVA in-kind, without a taxable event. They can then individually choose how to handle their inheritance. They could let their IOVA continue to grow tax-deferred, initiate a 1035 exchange which allows for an exchange into a different TDA (perhaps a more traditional one with a guaranteed stream of income for the rest of their lives), or they can liquidate their portion without creating a taxable event for the others. The remainder beneficiary can also be a charitable organization. This situation maintains the upward potential of the assets in the trust while still allowing for flexibility for all beneficiaries. The trustee has flexibility as well, to manage the portfolio as they see fit without concern for how their management style will impact the portfolio's taxation.

Gifts into Special Needs Trusts for a beneficiary with a disability is another example of how an IOVA may be a useful tool. The trustee can use the assets for the benefit of the beneficiary without the assets impinging on any state benefits for which the beneficiary might qualify. Were the assets owned by the beneficiary directly, their access to Medicaid or Supplemental Security Income (SSI) benefits would certainly be curtailed. Having an asset that does not create taxation issues within the trust is particularly important for young beneficiaries for whom the grantor wishes to provide support for their perhaps lengthy lifetime. At the same time, the use of a product that will incur an excise tax for distributions to beneficiaries under 59 1/2 makes this a situation requiring careful consideration with an advisor in order to thoughtfully weigh the long-term advantages and disadvantages of such a set up.

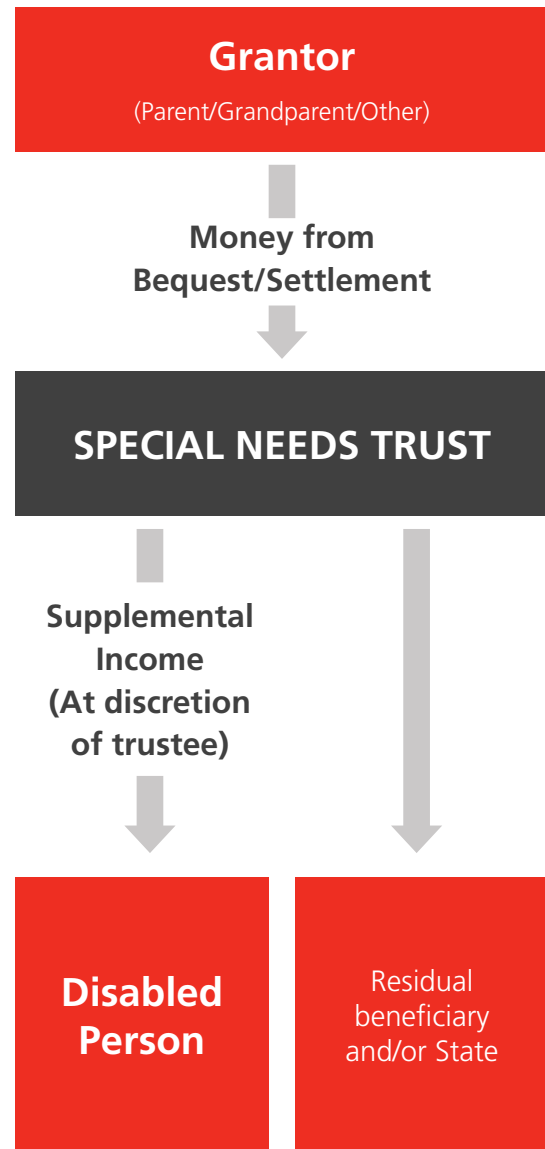
All of these examples illustrate the various ways a TDA can be a beneficial piece of a client's overall strategic estate plan. It can help avoid the trap of higher trust tax rates. As a result of their tax deferral and their investment platform, the portfolio has upward potential lacking in more traditional life insurance vehicles and is more easily managed without concern for tax inefficiency. The money that would have been distributed to avoid trust taxes instead remains in trust, which is the most beneficial outcome for the client and their various beneficiaries. Educating clients about updated annuity products, such as IOVAs, available to them can be an important part of putting together a sound and robust financial plan.

With Jackson Tax Deferred Annuities, you can enjoy:

- A fee-only advisory platform (no commissions, no withdrawal charges).**
- Institutional share class investments from well respected managers.
- Data feeds to power your trust software and the ability to model our products in planning software.

Variable annuities are long-term, tax-deferred investments designed for retirement, involve investment risks, and may lose value. Earnings are taxable as ordinary income when distributed and may be subject to a 10% additional tax if withdrawn before age 59^{1/2}.

**A contract charge and subaccount charges apply.



Before investing, investors should carefully consider the investment objectives, risks, charges and expenses of the variable annuity and its underlying investment options. The current contract prospectus and underlying fund prospectuses, which are contained in the same document, provide this and other important information. Please contact your Internal Wholesaler or the Company to obtain the prospectuses. Please read the prospectuses carefully before investing or sending money.

This material was prepared to support the promotion and marketing of Jackson® variable annuities. Jackson, its distributors and their respective representatives do not provide tax, accounting or legal advice. Any tax statements contained herein were not intended or written to be used, and cannot be used, for the purpose of avoiding U.S. federal, state or local tax penalties. Clients should contact their own independent advisors as to any tax, accounting or legal statements made herein.

Jackson's Private Wealth & Trust communications are intended only to alert you to strategies that may be appropriate for the circumstances described. Only a lawyer and/or tax specialist, after thorough consultation, can recommend a strategy suited to anyone's unique needs.

Add-on benefits are available for an extra charge in addition to the ongoing fees and expenses of the variable annuity. Once elected, benefits may not be canceled; please see prospectus for specific benefit availability. The long-term advantage of the add-on benefits will vary with the terms of the benefit option, the investment performance of the Variable Investment Options selected, and the length of time the annuity is owned.

Guarantees are backed by the claims-paying ability of the issuing insurance company and do not apply to the principal amount or investment performance of the separate account or its underlying investments. They are not backed by the broker/dealer from which this annuity contract is purchased, by the insurance agency from which this annuity contract is purchased or any affiliates of those entities, and none makes any representations or guarantees regarding the claims paying ability of Jackson National Life Insurance Company.

Annuities are issued by Jackson National Life Insurance Company® (Home Office: Lansing, Michigan) and in New York by Jackson National Life Insurance Company of New York® (Home Office: Purchase, New York). Variable annuities are distributed by Jackson National Life Distributors LLC, member FINRA. May not be available in all states and state variations may apply. These products have limitations and restrictions. Contact Jackson for more information.

Past performance is no guarantee of future results.

Jackson is the marketing name for Jackson National Life Insurance Company. Jackson National Life Distributors LLC.