Trust investments in life insurance and annuities

Discover the potential benefits of using life insurance and deferred annuities as investments in complex trusts — for trustees, income beneficiaries and remainder beneficiaries.

Reducing complex trust exposure to income taxes

Most of us know that federal income taxes can exact a hefty toll on earnings, with the top marginal rate now at 37 percent. In addition to progressive marginal rates, the so-called Affordable Care Act instituted a 3.8 percent surtax on net investment income (NII), which has the effect of placing higher-income taxpayers' investment earnings in a 40.8 percent marginal federal income-tax bracket.

At the same time, state income taxes have steadily increased, with many states now surpassing top marginal rates of more than 8 percent. In California, the top marginal rate is now 13.3 percent. The average top marginal rate for the 50 states and Washington, D.C., is 5.42 percent, which factors in the seven states that assess no income tax. The average of all states with an income tax is 6.28 percent.[1] At the same time, local income taxes are assessed in areas nationwide.

This combination is costing many high-income taxpayers up to half of their ordinary income in federal, state and local taxes. Taxation is particularly devastating to complex trusts and estates, which are subject to compressed federal income-tax brackets. In 2019, the 37 percent federal income-tax bracket for trusts and estates begins at $12,750, and the 3.8 percent NII tax applies to income in the top bracket. Trusts and estates therefore encounter the highest tax rate at a very low income level.

This reality can present difficulties to trustees who invest assets in situations where complex trusts are not distributing current-year income to trust beneficiaries.

> ***Example***
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> A husband's will created a bypass trust at his death. The trust provisions provide that the trustee may pay income and principal to the surviving wife for her health, education, maintenance and support. At the wife's death, the trust remainder will pass to the couple's children.
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> The surviving wife has sufficient income from other sources and doesn't need or request trust distributions. She wants to let the trust funds grow to maximize the distribution to her children.
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> The wife and children are not in the highest federal income-tax bracket. Yet because of the compressed brackets, the trust is subject to a 40.8 percent federal tax rate. When federal, state and local taxes are considered, fully half of the trust income is exposed to taxes. If the trustee distributes current income to the beneficiaries, the tax burden is reduced to the beneficiaries' rates. But the current income distribution does not accommodate the wife's wish to grow the trust principal.

In this situation, the trustee may feel that something must give. Either the tax exposure is reduced by making current distributions — and not honoring the wife's specifications — or the trust pays the highest income-tax rate and honors the wife's decision to let the trust principal grow.

A good solution is to invest trust assets in life insurance and deferred annuities. Both products offer tax deferral as cash values increase, and a life insurance policy death benefit is income-tax free.[2]

The technique and the result

Life insurance can offer substantial benefits when the surviving spouse is healthy enough to pass underwriting and receive standard or better rates. Permanent life insurance policies have cash value that can be accessed if the surviving spouse's financial situation changes and trust distributions are needed. If distributions are not needed and the policy pays the death benefit at the surviving spouse's death, these funds are received income tax free by the trust. The distribution of death proceeds from the trust to beneficiaries is likewise income tax free to beneficiaries. The result is a double win for the trustee: Loss of trust income due to taxes is minimized, and the beneficiaries receive a legacy income tax free.

Deferred annuities: A viable alternative

When the surviving spouse is uninsurable or highly rated, deferred annuities may be a viable alternative. Normally, a deferred annuity owned by a non-individual does not enjoy tax deferral on contract gains. Yet trusts that hold deferred annuities "as an agent for a natural person" do enjoy tax deferral.[3]

The IRS has ruled that bypass trusts, which hold deferred annuities on the lives of trust beneficiaries, are holding as the agent for natural persons and the contracts enjoy tax deferral. Plus, when a trust owns a deferred annuity, the mandatory payment at death rules are triggered by the annuitant's death, whereas the contract owner's death triggers payment when the contract is owned by an individual.[4]

This combination of rules can work to the trustee's benefit when investing in deferred annuities. The trustee can purchase a deferred annuity for each beneficiary naming him or her as the annuitant. When the surviving spouse dies, mandatory payment of the proceeds is not triggered because the annuitant has not died. The trustee may then distribute the deferred annuity contracts, in kind, to annuitants who are trust beneficiaries. The transfer to beneficiaries will not trigger taxation; instead, the beneficiaries enjoy tax deferral until they begin withdrawals from the contracts. Although tax is not avoided, the trust has minimized its exposure to income taxes, and the beneficiaries enjoy deferral until annuity distributions are made. At that time, income tax is based on each beneficiary's own tax rate.

Asset-based LTC products

In the example described above, suppose the surviving spouse's primary concern is that an extended long-term care (LTC) event would minimize the legacy for heirs. In this case, the trustee could purchase asset-based LTC coverage on the surviving spouse. Asset-based LTC coverage combines life insurance or deferred annuity policies with LTC coverage on the insured.

The typical configuration of a life insurance asset-based LTC policy basically involves a prepayment of a permanent life insurance policy's death benefit for qualified LTC claims. The LTC claim payments are received income tax free. And if there are no LTC claims, the insured's beneficiaries receive the life insurance policy death proceeds income tax free.

Asset-based LTC annuities enjoy tax deferral, like standard deferred annuities, when a trustee holds a policy as an agent for a natural person. As with life insurance LTC policies, the payments made from an asset-based LTC annuity for qualified LTC claims are received income tax free. Amounts remaining in the annuity policy at the annuitant's death are received by the annuitant's heirs as ordinary income to the extent taxable gain remains in the policy.

Whether using life insurance or annuities, asset-based LTC coverage can provide a triple win for a trustee. Loss of trust income to taxes is minimized, LTC risk is covered and the trust receives any remaining death proceeds, which can then be distributed to the remainder beneficiaries.

These concepts were derived under current tax laws. Any future tax law changes may adversely affect the effectiveness of these concepts. Withdrawals and loans from a life insurance policy reduce the life insurance policy's death benefit and cash value. Life insurance is not a retirement plan, investment or savings account.

1. "State individual income taxes for tax year 2018." Federation of Tax Administrators. January 2018.
2. Internal Revenue Code Section 101(a)(1).
3. Internal Revenue Code Section 72(u)(1).
4. IRS Let. Rule 199905015.