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IRS Rules on 1035 exchange by beneficiary

In Private Letter Ruling 201330016

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Considerations for 1035 exchanges

Until recently, when beneficiaries inherited nonqualified annuities, their options were very limited. In Private Letter Ruling 201330016, the Internal Revenue Service allowed a beneficiary of three annuity contracts to transfer those contracts from the original issuing company into one contract with a different company via a 1035 exchange. In this ruling, the IRS acknowledged that the beneficiary of the inherited annuity is "the new owner of the original contract" and, therefore, the technical requirements for a 1035 exchange were met on the post-mortem transfer of contracts by the beneficiary.

Distribution requirements remain unchanged — the beneficiary of an inherited nonqualified annuity is required to receive the money from the new account following the requirements of Internal Revenue Code Section 72(s).

The opportunity

PLR 201330016 opens the door for a number of planning opportunities for you and your clients.* Contract holders may want to exchange an inherited annuity for one with better features, benefits, investments or flexibility. Another consideration is whether or not the insurance carrier offers the option to stretch the payments over several generations through a nonqualified stretch provision.

The Lincoln solution

For a tax-advantaged income and wealth transfer strategy, Lincoln offers both fixed and variable annuity products, along with optional living and death benefit riders, to fit your clients' specific needs.

*While Private Letter Rulings are only binding for the taxpayer requesting it, they do provide insight and guidance into how the IRS may rule in similar situations.

Wealth transfer and income strategy

1

Research shows the average inheritance is spent within five years of acquiring it.[1]

It's important to understand your clients' income expectations and tax situation as well as how they want their wealth transferred to their beneficiaries.

Start by asking your clients these three questions:

#1: Would you like to be able to leave your beneficiaries with a steady stream of income?

#2: Are you concerned about the risks of leaving an inheritance?

#3: Do you think your taxes will increase in the future?

[1] Alessandro Martinello,"The Effect of Unexpected Inheritances on Wealth Accumulation: Precautionary Savings or Liquidity Constraints?," Lund University, KWC and SFI, Sept. 29, 2016, www.alemartinello.com/papers/inheritance_paper.pdf.

2

Using systematic withdrawals

If there are gains in the contract, systematic withdrawals start with the fully taxable gains being paid out first, resulting in less current income. If there are no gains, then all withdrawals are considered principal and are not taxed at all. Additional benefits of using systematic withdrawal include:

Increased flexibility—Instead of having to take payments as a lump sum or over a 5-year period, clients can stretch the tax consequence of any gains inherited over their lifetime, thereby reducing their tax impact.

Control of income—Clients are required to take a distribution that is based on the life expectancy factor of the beneficiary. This distribution must be taken by the first anniversary of the date of death of the original owner. However, clients can access more of their funds as needed.

LIFO tax distribution—Payouts to clients will be Last In, First Out (LIFO), so any gains will first be distributed from the contract, prior to their basis being returned. The return of basis is not taxable and should be a significant point for clients; however, they should consult with a tax professional about their specific situation.

Client legacy—Clients who leave assets to their beneficiaries can create a lasting legacy for their heirs. Each systematic withdrawal allows for an opportunity to remember the loved one that left the proceeds to them and creates a lasting legacy.

3

Stretch payments over generations

Rather than taking a distribution as a lump sum or over a 5-year period, the nonqualified stretch allows the beneficiary to meet a IRS distribution requirements by taking distributions over a period equal to their life expectancy and spread the tax on accumulated gains over their lifetime.

After a client passes, any remaining investment and income stream can continue for future generations.

Ask your Lincoln representative how you can help clients create a tax-advantaged wealth transfer and income plan.

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