



Will Power

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ANNUITIES INSIDE IRAs?

Why would anyone sell someone an annuity to hold inside of an Individual Retirement Account? For that matter, why would anyone sell someone an annuity to hold inside of a Family Trust, otherwise known as a Credit Shelter Trust? More importantly, why would anyone purchase an annuity inside one of these types of trusts? I suspect its because they don't know any better, and were taken advantage of.

I may get grief and angry letters from some financial professionals, and perhaps some of them will choose not to refer their clients to me. But the average consumer may not understand the consequences of these decisions, so I'm going to lay them out:

First, an individual retirement account is tax deferred. There really is no good reason to purchase an annuity inside of an IRA, because the annuity serves as a tax deferral strategy. In other words, when you put money inside of an annuity, it grows tax deferred. When you take the money out of the annuity, you pay ordinary income tax rates on the gain.

But the same holds true for an IRA. The IRA is tax deferred. So why not just invest in your normal stocks, bonds and treasuries? Why would an investment advisor suggest an annuity? Several years ago annuities offered guaranteed rates of return. That may be one legitimate reason. It is my understanding that annuities can't offer those guaranteed rates anymore.

I fear that the reason some planners recommend annuities is due to the commissions and ongoing management fees that the planners receive. While many planners have told me that I'm wrong about this, I haven't heard a reasonable explanation otherwise.

Same holds true in a Family Trust, (Credit Shelter Trust), only worse. Allow me to explain. When someone dies and their Revocable Living Trust divides into different

shares, those shares are typically called the Family Trust and the Marital Trust. The Family Trust is usually funded with the first assets, up to the amount that the deceased had remaining as a federal estate tax exemption amount. Today that amount is \$2 million. The excess, over that amount is usually placed inside the Marital Trust.

The Family Trust is typically held for the surviving spouse, paying her income for the remainder of her life. When she dies, the amounts remaining go the children or other beneficiaries.

If the Family Trust invests in normal stocks and bonds, then the capital gain that is paid when those stocks and bonds are sold is taxed at a rate ranging from twenty percent down to zero. If the Family Trust instead invests in annuities (presumably to generate the income for the surviving spouse) when those annuities are liquidated for the children they are often taxed at ordinary income tax rates, which can be as high as thirty five to forty percent! This is double the rate of the capital gains.

Moreover, the annuity will have had to outperform the regular stocks and bonds to account for the commissions and management fees the annuity incurs over those of the stock and bond portfolio. While the annuity may offer a "floor" guarantee of how much the trust will one day have (as opposed to stocks and bonds that may lose all of their value), the tradeoff doesn't seem to make a lot of sense.

Consider that the Family Trust can grow exponentially and not be subject to estate taxes, and that the annuity is not likely to grow exponentially, and you have some real questions that a financial planner must answer to. I'm not saying that there is no possible explanation, only that the annuity should be a last resort in very limited circumstances.

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