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.[1] Contractholders 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 annuity products with options to fit your clients' specific needs.

[1] 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.

A wealth transfer and income strategy

Research shows that about a third of those who receive an inheritance end up in the red after just two years.[2]

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. What concerns you about the way your financial legacy could impact your loved ones?
3. Do you think taxes will increase or decrease in the future?

Your action step – **Help clients take control by exploring a tax-smart strategy.**

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 IRS distribution requirements. They can take distributions over a period equal to their life expectancy, which spreads out the taxes due on the gains over their lifetime. Additional benefits include:

Increased flexibility

Instead of having to take payments as a lump sum or over a 5-year period, beneficiaries can stretch the tax consequence of any gains they inherited over their lifetime, which reduces the tax impact.

More control

Beneficiaries are required to take a distribution every year that is based on the beneficiary life expectancy factor. 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 if they want to.

Client legacy

Clients who leave money to their beneficiaries can create a lasting legacy. Each withdrawal gives beneficiaries the opportunity to remember the loved one that left the money to them.

LIFO tax distribution

Payouts to clients will be last-in, first-out (LIFO), so any gains will be paid out first from the contract, prior to the cost basis being returned. If there are no gains, then all withdrawals are considered principal and are not taxed. Clients should consult with a tax professional about their specific situation.

After the original beneficiary passes, any remaining investment and income stream can continue for future generations.

[2] Selena Maranjian, "What to Do With an Inheritance," *The Motley Fool*, July 25, 2019, https://www.fool.com/retirement/what-to-do-with-an-inheritance.aspx.

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

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LCN-2945951-021020
POD 3/20 **Z02**
Order code: LFD-1035-BRC001

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