**535. What is a Medicaid compliant annuity?  How can Medicaid compliant annuities be used in an individual's planning?**

A married couple typically purchases a Medicaid compliant annuity if the two spouses are in unequal health positions to ensure that the healthy spouse—known as the “community” spouse—has sufficient income, while allowing the second, less healthy, spouse to qualify for Medicaid assistance in paying for long-term care expenses, typically within a nursing home.

Rather than treating the purchase of the annuity as an impermissible asset transfer effected in order to meet Medicaid’s means-tested eligibility requirements, if the requirements discussed below are satisfied, the federal Deficit Reduction Act (DRA) treats the purchase as a permissible exempt investment, and the annuity payout stream is shielded as the community spouse’s income.

In order to qualify as a Medicaid compliant annuity under the DRA, the terms of the annuity contract must satisfy certain criteria. The income from the annuity contract must be payable to the community spouse, the contract must be irrevocable, and the payment term must be based on the life expectancy of the community spouse.

This is because, in a situation where one spouse requires long-term care and the other remains in the community, the assets of the community spouse are counted—up to a certain level—in determining whether the institutionalized spouse qualifies for Medicaid, but the *income*of that spouse is not counted.

Further, the state must be named as the remainder beneficiary on the contract, allowing it to receive up to the amount that it has paid for the institutionalized spouse’s long-term care.

**516. How can an annuity be used by an individual as an estate planning tool?**

In order to avoid the potential tax and financial repercussions that a lump sum transfer can create, many individuals wish to protect their heirs by providing structure to the way assets are inherited. For these taxpayers, annuities, though commonly used as retirement income planning tools, can provide the solution.

A taxpayer may wish to use annuities to structure an inheritance for a variety of reasons. The reasons for using an annuity as a wealth transfer vehicle often mirror those that apply when a taxpayer is planning for retirement—the annuity creates a stream of consistent income over time, guaranteeing that the taxpayer’s beneficiary is provided for far into the future. This strategy can provide protection for heirs

who might be otherwise unable to manage a large one-sum payment, or who might have financial problems that could cause them to spend a large sum too quickly.

Some annuity contracts also offer a feature called a restrictive endorsement that can prevent the heir from selling or assigning his or her rights in the annuity contract, providing further protection for the income stream.

Further, individuals might wish to include an annuity in their estate planning in order to ensure that specific beneficiaries are provided for outside of the overall estate plan. Purchasing annuity products can provide income security for those specified heirs while allowing the remaining estate assets to be used to accomplish other goals—such as satisfying estate expenses or allowing remaining assets to be invested more aggressively in riskier investments that have the potential to generate more growth.

Structuring the payments so that they occur over time, as an annuity stream, rather than as a lump sum payment, can help the account beneficiaries avoid a large up front tax liability. This is because, unlike life insurance death proceeds, proceeds received under annuity contract are not entirely tax-exempt. For some taxpayers, however, an annuity product that provides a lump sum death benefit can prove attractive because it can often be used as both a retirement and estate planning vehicle—meaning that the taxpayer can receive annuity payments during life in order to meet retirement income needs and still ensure that a portion of the annuity investment benefits his or her heirs.

**489. What are the new rules that allow 401(k) plan sponsors to include deferred annuities in target date funds?**

IRS Notice 2014-66 specifically permits 401(k) plan sponsors to include deferred annuities within TDFs without violating the nondiscrimination rules that otherwise apply to investment options offered within a 401(k). This is the case even if the TDF investment is a qualified default investment alternative (QDIA)—which is a 401(k) investment that is selected automatically for a plan participant who fails to make his or her own investment allocations.

Further, the guidance clarifies that the TDFs offered within the plan can include deferred annuities even if some of the TDFs are only available to older participants—even if those older participants are considered “highly compensated”—without violating the otherwise applicable nondiscrimination rules. Similarly, the nondiscrimination rules will not be violated if the prices of the deferred annuities offered within the TDF vary based on the participant’s age.

The new guidance will allow plan sponsors to include annuities within TDFs even if a wide age variance exists among the plan’s participants. Additionally, the new rules allow plan sponsors to provide a participant with guaranteed lifetime income sources even if the participant is not actively making his or her own investment decisions with respect to plan contributions—a situation which is increasingly prevalent as employers may now automatically enroll an employee in the 401(k) plan unless the employee actively opts out of participation.

**536. What is a private placement variable annuity (PPVA)??**

A PPVA investment is an annuity that is available only to high net worth individuals who qualify as accredited investors (and, practically, qualified purchasers), meaning that they meet certain requirements as to net worth and investment sophistication. It is an annuity in that it is treated as such for tax purposes, but the similarities to the traditional retail annuities that most taxpayers associate with the term ends there—PPVA investments do not offer the types of income guarantee riders and protection against market risks that today’s retail annuities typically make available.

Instead, the draw of the PPVA investment is the investment flexibility and tax-deferred growth that these types of accounts offer. The taxpayer has the freedom to made additional deposits to the annuity and change his or her investment allocations based on a number of investment options—typically, these annuities will provide a choice of investments that includes non-traditional investment options, such as hedge fund and private equity investments that have the potential to generate substantial returns.

Taxes on the account growth are deferred until the taxpayer begins taking annuity payouts (a 10 percent penalty charge applies if distributions begin before the taxpayer reaches age 59 ½). In order to qualify for this favorable tax treatment, the PPVA investment must offer only investment options that are available solely to qualified insurance companies.

Further, the underlying asset allocations must meet certain investment diversification requirements—for example, no more than 55 percent of the individual’s assets may be allocated to any single investment and no more than 70 percent may be allocated to any two investments. The taxpayer has control over his or her investment allocations, but cannot have control over the investment *choices* that are offered within the PPVA investment—an independent investment manager must have discretion to choose the investments that will be made available to the taxpayer.