

Sales Strategy

Monthly publication describing timely and useful sales ideas and concepts.

ANNUITY MAXIMIZATION

(Estate Planning for Deferred Annuities)

INTRODUCTION

Clients often invest in tax-favored investments like deferred annuities to supplement their retirement savings. As clients grow older and more affluent, their potential estate tax exposure becomes a bigger problem than their retirement planning needs. Some clients no longer need the annuity for income purposes. As discussed below, the deferred annuity may be subject to both income and estate taxes. However, lifetime planning can minimize taxes and increase the amount left to heirs.

Advanced Markets has introduced the MLI SolutionsSM System to help you demonstrate to your clients the benefits and affordability of life insurance for estate planning. Annuity Maximization is a planning tool designed to illustrate the income and estate tax consequences of owning a deferred annuity at death.¹ Annuity Maximization provides two detailed strategies that may enable your clients who already own deferred annuities to maximize the amount left to heirs while minimizing the amount passing to the government. Annuity Maximization illustrates:

Income and Estate Tax Impact of Owning Deferred Annuities	Maximizing Wealth to Heirs	Funding Strategies Using the Annuity
Potential "Double Tax" Bite at Death	Annual Exclusion Gifts Funded with Income Annuity	Conversion Option
	Annual Exclusion Gifts Leveraged with Life Insurance	Withdrawal Option

INCOME AND ESTATE TAXES

Annuities are often attractive to clients desiring supplemental retirement income because of the income tax deferral available. However, deferred annuities not consumed during the clients' lifetimes may not be the best investment to own at death. Deferred annuities owned at death are often subject to both income and estate taxes, which greatly diminishes the amount that may be passed to the clients' heirs. For estate tax purposes,

the full fair market value of a deferred annuity (in the accumulation phase) is includable in the decedent owner's gross estate. Additionally, deferred annuities have "built-in" income tax consequences which are payable even after death.²

The deferred annuity owner's heirs do not get a "stepped-up" basis at death. The income tax liability is determined by taking the premiums paid (the owner's basis) less the annuity's fair market value (the cash value build-up).³ The cash value build-up in excess of basis is taxable as ordinary income to the owner's estate at death or to the owner's beneficiary upon surrender or receipt of the annuity payments.⁴

The net amount that heirs will receive from a deferred annuity is reduced by any estate, generation-skipping, and income taxes that may be due. Will there be sufficient liquid assets available to pay these taxes? Like qualified plan assets, liquidating the annuity to pay estate taxes will trigger current income taxes – creating an additional need for liquidity. The result? In some instances, the annuity may experience a total "meltdown". The annuity may have to be surrendered to pay the income and estate taxes which sometimes results in a loss of more than 70% of the annuity's value!

If the clients understand their "meltdown" exposure at death, the next step is to confirm that the deferred annuity is not needed for the clients' retirement. If not, the clients may consider integrating the deferred annuity into a lifetime gifting strategy. MLI Solutions *Giftng Analysis* is an effective tool to help your clients determine if gifting increases the amount received by their heirs. If the clients agree that lifetime gifting is economically feasible, the next question is: is the annuity an effective asset to fund these gifts? Since the deferred annuity is double-taxed at death, the answer is often yes. Annuity Maximization is designed to assist clients with making this decision.

MAXIMIZING WEALTH TO HEIRS

Convenience of Annual Exclusion Gifts. Annual exclusion gifts are a simple way for clients to reduce their taxable estates. The annual exclusion is the amount of money that may be annually gifted from any individual to any other individual without incurring gift taxes or expanding applicable exclusion amount (formerly "unified credit"). The maximum annual exclusion gift is \$10,000 per recipient per year in 2001, and will be indexed for inflation (rounded down to the nearest \$1,000).

Annuity Maximization and Insurance Funding. Annuity Maximization helps clients understand the benefits of turning an unneeded annuity into an effective funding source for the clients' lifetime gifting strategy. The after-tax cash from the annuity may be used to fund annual exclusion gifts to an irrevocable life insurance trust (ILIT), and the ILIT trustee then buys life insurance on the client and/or the client's spouse. With this strategy, the clients can often pass more wealth to heirs than if the deferred annuity is held until death.

Conversion Versus Withdrawal. The issue remains whether converting the deferred annuity into an immediate annuity or taking withdrawals from the deferred annuity is the more cost-efficient method of funding the annual gifts. The risks, benefits, and costs of conversion or withdrawing should be considered before making this decision.

Conversion. Clients can convert a deferred annuity into an immediate annuity.⁵ The immediate annuity provides a consistent, predictable stream of income to fund the annual gifts. The clients will then have an asset that they can dedicate to their gifting strategy, and they do not have to worry about outliving their source of funding. Conversion provides a simple method of funding annual exclusion gifts.

Withdrawals. After a number of years, annuities often allow owners to withdraw a small percentage of the annuity each year without penalty or surrender charges.⁶ These preferred withdrawals allow clients to begin annual exclusion gifting without the psychological trauma of “losing the asset.” If clients become more comfortable with the idea of dedicating the annuity to their annual gifting program, the annuity can always be converted later. Risk averse clients may prefer annuitization as a more predictable method of funding.

EXAMPLE

Background. Wayne (age 64) and Fran (age 61) Kershner, both non-smokers preferred risk, are near retirement, and their estate has grown far beyond their expectations. During Wayne’s working years, he and Fran have diligently put aside money for their retirement in a deferred annuity. Wayne spent years building up his printing company, Quick Print. Both the Kershners were surprised by the success of their business as well as the success of their investments. Their current assets are as follows:

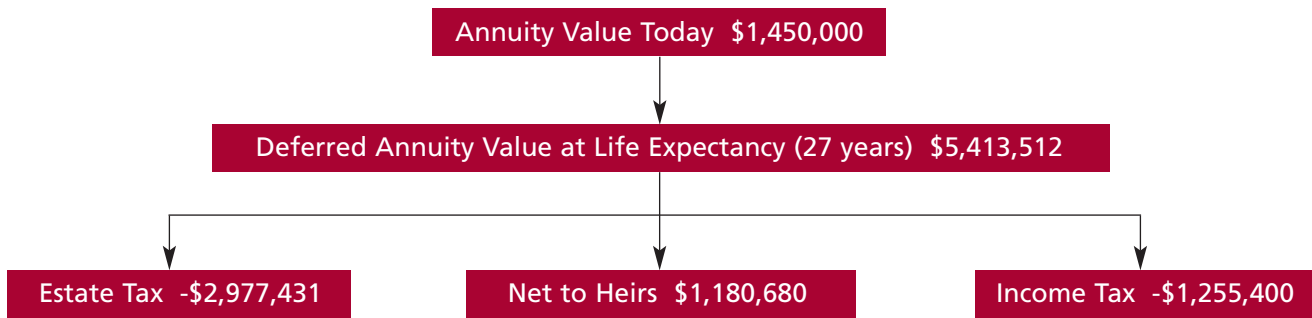
Asset	Value
Quick Print	\$3,000,000
Investment Real Estate	\$1,200,000
Personal Property and Residence	\$450,000
Securities and Cash	\$1,400,000
Deferred Annuity	\$1,450,000
TOTAL	\$7,500,000

The Kershners’ success will allow them to retire with income beyond their most optimistic expectations. They had planned on retiring on the income from their deferred annuity, but they now find that their income from other sources is more than adequate. However, they are still reluctant to part with the annuity. They feel that the annuity with the continued tax-deferred growth will be a great way to pass money along to their six children. After meeting with their financial advisor they realize that if they retain the annuity, income and estate taxes will seriously erode the value passed to their children.⁷

After reviewing the estate tax analysis for their annuity (See Figure 1), the Kershners understand their “meltdown” exposure and realize that they still need to address the issue with lifetime gifting.^{8,9} They should consider whether conversion or withdrawals is the most effective way to fund their annual gifts.

FIGURE 1 • CURRENT SITUATION WITHOUT PLANNING

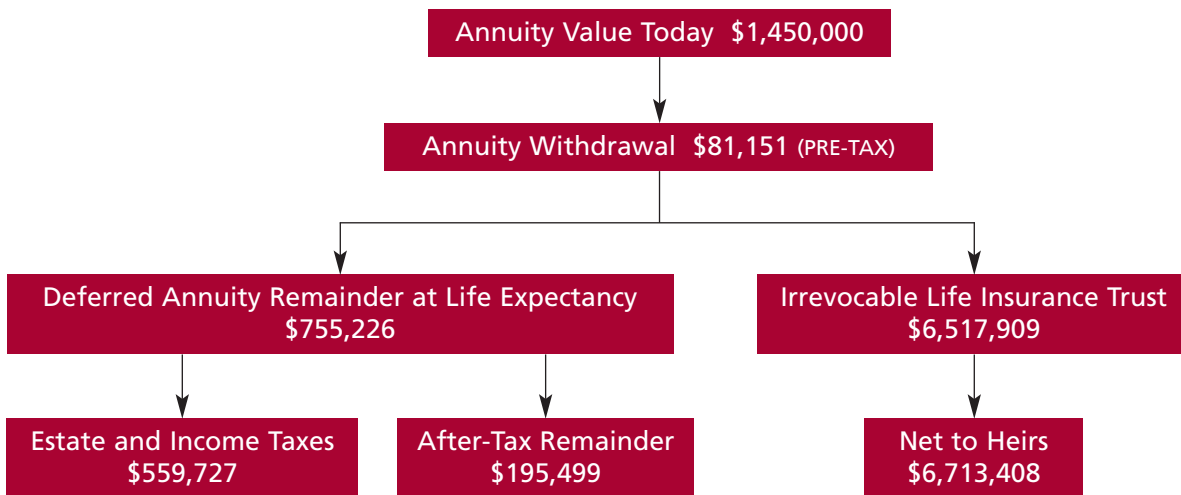
(Simulated flow-chart from Annuity Maximization)



Withdrawals. The Kershner's deferred fixed-income annuity is earning 5% a year. The Kershners contact their annuity carrier, get an in-force illustration and discover that they are allowed to withdraw \$81,151 a year penalty-free. After income taxes at the top marginal rate of 39.1%, this represents a net withdrawal of \$49,421 that is available for annual exclusion gifts to their children.¹⁰ The Kershners give this money to an ILIT and the trustee purchases a \$3,382,813 Survivorship Variable Universal Life (Survivorship VUL) contract with an increasing face amount.¹¹ (See Figure 2 below.)

FIGURE 2 • WITHDRAWALS

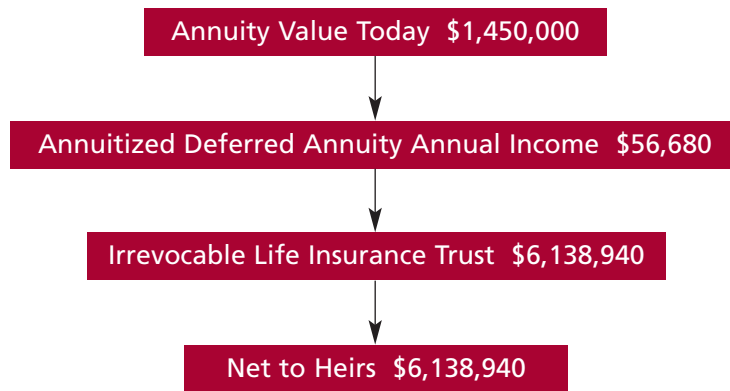
(Simulated flow-chart from Annuity Maximization)



Conversion. Wayne and Fran like the results of taking withdrawals from their annuity and purchasing life insurance. However, they should still consider the conversion option before making a decision. They obtained an annuitization quote from their existing deferred annuity carrier and are also considering an illustration for Manulife's single premium immediate annuity. Given their ages and the rate in effect on July 13, 2001, a lifetime annuitization with a survivorship feature would provide \$89,619 in annual payments (\$5,377 as return of principal and \$84,242 of taxable income). At the top income tax bracket, the Kershners will receive \$56,680

after-tax each year. They can give the \$56,680 to an ILIT¹² for their six children using annual exclusion gifts without paying gift tax or using unified credit. The ILIT trustee can use the gifts to purchase a Survivorship VUL contract with an increasing death benefit of \$3,607,422.¹³ Assuming the Kershner's convert and then both die at life expectancy (year 27), their heirs will receive the following as beneficiaries of the ILIT. (See Figure 3 below.)

FIGURE 3 • CONVERSION



The Kershners decide to convert their deferred annuity to a single premium immediate annuity.¹⁴ They like the security and convenience of the conversion option. Not only does conversion provide a higher death benefit at life expectancy, but the annuity payments are guaranteed to continue no matter how long they live.

CONCLUSION

When clients face an estate tax exposure and own a deferred annuity, a financial advisor should explore the possibility of lifetime planning with the deferred annuity. Deferred annuities are not an asset recommended for wealth transfer. However, the annuity may be an ideal source to fund annual gifts of the insurance premiums to an ILIT. The life insurance in the ILIT can leverage the net worth left to the clients' heirs. Withdrawals or conversion of the annuity should be explored as possible funding alternatives. Advisors with access to MLI Solutions Annuity Maximization now have a single, integrated system which can illustrate to the clients: 1) the benefits of lifetime planning versus holding the annuity at death; 2) the benefits and short-falls of the funding strategies (withdrawal or conversion); and 3) the leverage of annual exclusion gifts using life insurance in an ILIT.

For more information on estate planning with annuities or using Annuity Maximization, please contact your local Manulife Financial Representative or the Advanced Markets Group at 1-888-266-7498, option 3.

- 1 This Sales Strategy does not address qualified deferred annuities (i.e., the issues regarding an annuity owned in a qualified plan or IRA).
- 2 IRC Code Section 691 provides that income in respect of a decedent (IRD) not included in the decedent's final tax return shall be included in the decedent's gross estate or as income to the recipient of the IRD assets. However, the person taking the IRD into income will receive an income tax deduction for the portion of the estate tax attributable to the IRD income.
- 3 IRC Regulation Section 1.72-11(c).
- 4 The annuity beneficiary can avoid current income recognition of the gain on the annuity by electing within 60 days of the annuitant's death to settle under a life income or installment option. See IRC Section 72(h).
- 5 This article assumes a life only annuity (joint life expectancy) with no refund features.
- 6 Each annuity carrier has specific rules, and the carrier should be contacted about its rules. Most annuity owners must be older than 59 ½ and have owned the annuity for a number of years to begin to take withdrawals without penalties. The income tax consequences of withdrawals still apply.
- 7 Assumes pre-tax growth rates of 5% for the annuity and 4% on the remainder of the estate, income tax rate of 39.6%, and a cost basis of \$150,000 for the annuity.
- 8 Under the Economic Growth and Tax Relief Reconciliation Act of 2001, the estate tax will be phased out between 2002 and 2009, with a full repeal of the estate tax in 2010. However, due to the "sunset provision" in the Act, the new tax law provisions will expire after December 31, 2010, and will return to current law, unless Congress and the President renew the Act. The estate tax analysis on the examples in the Sales Strategy have been run with the assumption that the Act will not be renewed and that in year 27 (life expectancy for the examples), the estate tax exemption will be \$1,000,000 per person.
- 9 Surrendering or taking withdrawals from an existing annuity may result in substantial charges including, but not limited to, surrender charges, deferred or contingent sales loads, income, and excise taxes. Annuity owners should confirm these charges or penalties prior to making any decision regarding their annuity.
- 10 The children as ILIT beneficiaries need to possess withdrawal powers often known as "Crummey Powers". These "Crummey Powers" are used to qualify the gift for the annual gift tax exclusion. Creating and funding an ILIT is a sophisticated estate planning technique, and the clients' legal and tax advisors should be consulted prior to any decision based on these materials. Estate and Income taxes are calculated at 39.1%
- 11 The premiums paid for Mr. and Mrs. Kershner's Survivorship VUL contract are based on rates for a male, age 64, preferred, non-smoker and a female, age 61, preferred, non-smoker Massachusetts residents. At 0% maximum charges the policy is guaranteed to stay in force until the second insured reaches age 100.
- 12 The premiums paid for Mr. and Mrs. Kershner's Survivorship VUL contract are based on rates for a male, age 64, preferred, non-smoker and a female, age 61, preferred, non-smoker. At 0% with maximum charges the policy is guaranteed to stay in force until the second insured reaches age 100. Survivorship VUL is issued by The Manufacturers Life Insurance Company of America and issued by ManEquity Inc. or other broker/dealers appointed by ManEquity Inc.
- 13 "No planning" assumes both spouses die while the annuity is in the accumulation phase, and estate taxes are proportionately paid from the annuity proceeds with the remainder going to the heirs. "Withdraw" assumes "preferred" withdrawals, after-tax annual gifts qualifying for the annual gift tax exclusion, and ILIT is permitted to and owns life insurance.
- 14 "Annuitize" assumes converting the deferred annuity to an immediate annuity, the after-tax annuity payments qualifying as annual exclusion gifts, and ILIT is permitted to and owns life insurance.

Sales Strategy is produced by Manulife Financial's Advanced Markets Group. We can be reached at 1-888-266-7498, option 3.

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