



ANNUITY MAXIMIZATION STRATEGY



Preserving Hard-Earned Annuity Assets

Alternatives to help protect financial assets, increase current income stream, or decrease income tax liabilities

As part of a solid financial plan, many people purchase deferred annuities as an accumulation vehicle that also helps to delay federal and state income taxes.

The good news is that, over the years, the contract has probably grown substantially in value. And the bad news? Despite the advantage of income tax deferral, these annuities may lose a sizable portion of their value at the owner's death.*

A Taxing Example

Mike Megaworth purchased a \$150,000 deferred annuity contract 20 years ago, earning an average of 6% annually. He is now 70 years old and the annuity is worth \$481,070. Mike has a taxable estate of \$2,481,070 in the 45% marginal federal estate tax bracket. His daughter, Martha, is the beneficiary of the annuity contract and is in the 35% federal income tax bracket. What would happen to the contract's account value if Mike were to die and it were left to Martha?

Contract value at death	\$481,070
Estate tax	- 218,482
Income tax**	- 63,731
Value retained by beneficiary	\$200,857

Why Deferred Annuities May Lose Over Half Their Value

As the example shows, even after 20 years of tax-deferred savings, Martha would only receive a little less than half of the contract's value. A significant amount—58%—would be lost to taxes.

Here's why: Under current tax laws, at the annuity owner's death, contract gains are completely income taxable to the beneficiaries as income in respect of a decedent (IRD), while other assets, such as individual stocks, receive special tax treatment (a step-up in basis), which may reduce the income tax liability if they are sold by heirs.

Moreover, the contract's value may be subject to estate taxes at the owner's or spouse's death. Plus, during the owner's lifetime, any amount of gain received from an annuity contract is taxed as ordinary income even if the annuity holds a type of investment, such as stocks or bonds, which would typically be subject to the capital gains rate. There may also be an additional federal income tax penalty on the taxable portion of the amounts received if the owner is under age 59^{1/2}.

Annuity Alternatives Offer Choices

There are alternatives to help protect financial assets, increase current income stream, or decrease income tax liabilities.

The above example is for illustrative purposes only. It does not address the impact of applicable state income and death taxes, nor does it reflect any deductions and credits that could be available to reduce the overall estate and income tax liabilities under certain circumstances.

* Tax deferral is only available to individuals. It is not available for annuities owned by entities such as corporations and most types of trusts.

** After an allowance for the original cost basis of \$150,000 and an income tax deduction of \$148,982 for estate taxes attributable to the income element of the contract $[0.45 \times (481,070 - 150,000)]$, \$182,088 of the contract's value would be subject to income taxation at 35%.

Option One: Annuitizing the Contract

- The owner elects to receive annuity payments over the owner's lifetime, joint lifetimes of the owner and spouse, or a fixed period of time. A portion of the owner's basis in the annuity will reduce the taxable amount of each payment.
- This technique may reduce the overall income tax effect when compared to surrendering the contract, since the owner will recognize taxable income over a number of years rather than in just one tax year.
- If the annuity owner is also receiving Social Security benefits, it's less likely that the receipt of annuity payments will affect the taxation of these benefits in any one year than if the owner had surrendered the entire contract.
- If a life annuity payment option is selected, payments will stop at the death of the owner (or at second death if joint life), with no additional annuity value subject to estate taxes. If a period certain option is selected and death occurs before the term of the annuity has expired, the remaining annuity payments will go to the beneficiaries. The value of these remaining annuity payments will also be included in the estate of the annuity owner.

Option Two: Taking Periodic Withdrawals

- Rather than selecting an annuity option, the owner can also take withdrawals from the annuity contract for periodic income needs.
- For annuity contracts purchased after August 13, 1982, withdrawals will be taken from the gain or interest portion of the contract first, and taxed as ordinary income. After all the gain or interest has been withdrawn, then withdrawals from basis (or investment) in the contract are taken, which are not taxable. This is referred to as "LIFO"—"last-in, first-out."
- Furthermore, if the contract owner is under age 59½, there may be an additional 10% federal income tax penalty on the taxable portion of withdrawals.
- Depending on contract terms and amounts needed, company-imposed surrender charges may also apply.

Annuity Maximization Strategy

Under either of the options previously discussed, the annuity beneficiaries will likely see a reduction in their inheritance at the death of the annuity owner. However, depending on risk tolerance and financial goals, the annuity owner can purchase a separate life insurance policy to offset the reduction. Unlike the deferred annuity contract, the life insurance policy can generally pay its benefits to beneficiaries federal income tax-free. In addition, if the policy is owned by a third party—such as the adult children or an irrevocable trust—the life insurance policy and proceeds may be kept out of the taxable estate.

The annuity owner may want to use a portion of the annuity income to pay the life insurance policy premium. If the annuity owner chooses the withdrawal option rather than annuitizing the contract, he or she must be over age 59½ to avoid the 10% federal income tax penalty. If the life insurance policy is owned by a third party such as a trust, there may be gift taxes associated with the money used to pay the life insurance premiums. However, annual exclusions and lifetime credits may offset any gift tax liabilities.

Life insurance is the key to this planning strategy. Policy proceeds are generally paid to beneficiaries federal income tax-free and, if structured properly, can be kept out of the taxable estate. As a result, the family's legacy is protected for future generations.

Who Can Benefit from the Annuity Maximization Strategy?

- Individuals who want the death benefit protection and cash accumulation values of a permanent life insurance policy
- Annuity contract owners interested in maximizing an inheritance for their loved ones.

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Annuity Maximization Strategy Fact Finder

Client Information

Owner Name _____

Date of Birth _____ Smoker? _____ Risk Class _____

Spouse Name _____

Date of Birth _____ Smoker? _____ Risk Class _____

Is spouse joint owner? Yes No

State of Residence: _____

Owner's Income Tax Bracket: _____% Owner's Estate Tax Bracket _____%

Beneficiary's Income Tax Bracket: _____%

Current Value of Annuity: \$ _____ Annuity Cost Basis: \$ _____

Annuity Contract Value Growth Rate: _____%

Initial Life Insurance Policy Death Benefit: \$ _____

Taxes on Withdrawal Paid Out of Pocket: Yes No

Life Insurance Product to Illustrate: _____

Cash Surrender Value at Age 100: _____

Endow Equal to Initial Face Amount: _____

The proposal will assume annual premium payments through insured's age 100
(younger insured's age is used with survivorship policies).



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