John Hancock
LIFE INSURANCE


SALES STRATEGY

WEALTH TRANSFER | Advanced Markets

# Annuity Maximization

## Maximizing the Value of an Annuity By Using Life Insurance

### The Concerns

Clients who have purchased a deferred annuity may find that they no longer need the annuity for retirement income purposes. Often, these clients intend to "leave it for the kids." Although a deferred annuity is a great vehicle to accumulate funds for retirement, it is not an efficient vehicle to transfer wealth since it may be taxed twice at death. How can your client protect the value of the annuity for heirs? By reducing or replacing the annuity with more tax-efficient vehicles.

Depending on ownership structure, a deferred annuity may be subject to both ordinary income and estate taxes at death (the gain on an annuity is subject to ordinary income tax and the annuity is part of a client's taxable estate). This could potentially erode the annuity up to 70%. The result is that your client's heirs will receive a fraction of the intended amount. To solve this problem, clients can reposition, or maximize, the deferred annuity.

### The Solution

Annuity Maximization is simply an asset repositioning strategy.

The first step is to utilize the annuity to fund the life insurance. The client has two choices. They can:

1. **Convert the annuity to a Single Premium Immediate Annuity (SPIA).** A SPIA provides an income stream for a number of years based on a single deposit as well as the client's age and health status. Choosing this method can provide a consistent, predictable stream of income to fund a life insurance policy. Since the income stream is based on a life-only annuity, your client will not outlive the income. A portion of each payout is excluded from income tax until this equals cost basis in the annuity. Your client may make gifts of the after-tax income generated from the SPIA to an Irrevocable Life Insurance Trust (ILIT) if estate taxes are a concern.[1]
2. **Take withdrawals.** Clients who are unwilling to give up their annuity may instead take withdrawals from it to fund a life insurance policy. This way, the client can still maintain control of the asset and taxes can still be minimized since the value of the annuity in the estate will be reduced by the withdrawals. However, depending on the specific annuity contract, withdrawals may be subject to surrender charges or penalty taxes if taken prior to age 59½.

Determining which method is best depends entirely on your client's preference. The risks, benefits, and cost of conversion or withdrawals from an annuity should be considered before making a decision.

Either way, potentially more can be transferred to heirs estate and income tax-free when an Annuity Maximization approach is used.[2]

| THE PROBLEM | THE SOLUTION | THE RESULT |
|---|---|---|
| Annuities are taxed at death; up to 70% of the annuity may be taxed. | ▮ Convert deferred annuity to SPIA, or take annuity withdrawals.<br>▮ Leverage distributions of SPIA to fund life insurance. | Increase the amount transferred to heirs, as life insurance is a more tax-efficient vehicle. |

## Considerations (if estate taxes are a concern)

Your client may make gifts of the after-tax income generated from the annuity to an Irrevocable Life Insurance Trust (ILIT). The ILIT then has the funds to purchase a life insurance policy on your client's life for an amount that replaces (or exceeds) the value of the deferred annuity to benefit heirs.

**Annual Exclusion Gifts.** An annual exclusion gift is the amount of annual gifts that each individual can make to an unlimited number of people without federal gift tax. In 2013, the amount is $14,000 per individual per year, indexed annually for inflation and subject to specific qualifying rules. Making annual exclusion gifts of the SPIA income, or the distributions from the deferred annuity, can be a tax-efficient way to leverage and transfer wealth.

**Lifetime Exemption Gifts.** In addition to the annual exclusion gifts, each individual has a lifetime exemption amount (also referred to as applicable gift tax exclusion) to use during lifetime before gift taxes apply ($5.25M in 2013).

### CASE STUDY: SAM AND MAGGIE MALONE

**CLIENTS:** **Sam and Maggie Malone**

**STATUS:** Ages 65 and 62, Preferred Non Smokers, 30% Tax Bracket. They own a deferred annuity of $750,000 growing at 5% annually (cost basis of $400,000). The Malones take annual withdrawals of $21,600 after taxes.

**PRODUCT:** They purchase a Current Assumption Survivorship Universal Life policy, which buys approximately $2.2M of death benefit using a $21,600 premium.

### COMPARISON OF VALUES IN YEAR 30

| | | CURRENT STRATEGY | PROPOSED STRATEGY |
|---|---|---|---|
| Annuity Today | | $750,000 | $750,000 |
| Annuity Cost Basis | | $400,000 | $400,000 |
| Total Premiums Paid by Year 30 | | | $648,000 |
| Annuity in Year 30 | | $3,241,457 | $1,088,848 |
| Income in Respect of a Decedent Taxes | – | $852,437 | $206,654 |
| Death Benefit in Year 30 | + | | $2,200,000 |
| **Net to Heirs in Year 30** | = | $2,389,020 | $3,082,194 |
| **Potential Gain Due from Planning** | | | $693,174 |

The figures used in this case study are hypothetical, for discussion purposes only, are not guaranteed and may not be used to project or predict results. Actual results may be more or less favorable. Specific product and policy elements would be found in a policy illustration provided by an insurer. With any decision regarding the purchase of life insurance, a client would need to determine which type of life insurance product is most suitable for their specific needs.

### SUMMARY

Using JH Solutions, show your client how repositioning a deferred annuity to fund life insurance is a great way to maximize the amount passed on to heirs. Since an annuity may be subject to both income and estate taxes at death, replacing it with a Single Premium Immediate Annuity or reducing it through withdrawals can help your client create a larger legacy for future generations.

For more information on Annuity Maximization with deferred annuities, please contact your local John Hancock Representative or call the Advanced Markets Group at 888-266-7498, option 3.

1. Trusts should be drafted by an attorney familiar with such matters in order to take into account income and estate tax laws (including generation-skipping transfer tax). Failure to do so could result in adverse tax treatment of trust proceeds.
2. Life insurance death benefit proceeds are generally excludable from the beneficiary's gross income for income tax purposes. There are a few exceptions such as when a life insurance policy has been transferred for valuable consideration. No legal, tax, or accounting advice can be given by John Hancock, its agents, employees, or registered representatives. Prospective purchasers should consult their professional tax advisor for details.

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