

Annuity Maximization: A Strategy to Leave More to Your Heirs

What if you're living comfortably in retirement and find that you don't need a deferred annuity you bought years ago? Instead, you want to leave it to your heirs at your death. What you may not know is that transferring your deferred annuity at death may subject it to both estate and income taxes. A strategy that can minimize the impact of these taxes is called annuity maximization using permanent life insurance.

Some background

When you die, the portion of the annuity death benefit received by your beneficiaries (either in a lump sum or as periodic payments) that exceeds your investment in the annuity is includible as taxable income to your beneficiaries.

In addition, the full accumulation value of your deferred annuity is includible in your gross estate at death. If your estate is large enough to owe federal and/or state estate taxes, your deferred annuity will be subject to those taxes as well.

The combination of estate and income taxes can erode a significant portion of your annuities value. The result is that your beneficiaries may receive an annuity worth much less than you anticipate.

How annuity maximization works

Here's the basic way this strategy works: you exchange your deferred annuity for a single premium immediate annuity (SPIA) that provides an income stream to you for the rest of your life. You then obtain permanent life insurance with you as the insured, and use the SPIA distributions to pay the insurance premiums. At your death, the SPIA payments stop and the insurance proceeds are paid to your beneficiaries.

Alternatively, if you prefer to retain the deferred annuity instead of converting it to a SPIA, you may be able to take penalty-free withdrawals from your deferred annuity, which can also be used to pay the insurance premiums. However, annuities vary as to penalty-free withdrawal availability, so for complete details, be sure to check with the annuity issuer, or review your annuity contract or prospectus.

Caution: Annuity distributions before age 59½ may be subject to a 10% federal tax penalty. Annuity guarantees are based on the claims paying ability of the annuity issuer.

The annuity maximization strategy may pose some income tax issues for you. SPIA payments and annuity withdrawals may be taxable to you. A portion of

each SPIA payment you receive is subject to income taxes and a portion is considered a non-taxable return of premium. Conversely, withdrawals from your deferred annuity (for annuities issued after 1982) are taxed as income first, meaning the entire withdrawal is includible as income until all of the annuity's earnings are withdrawn, after which withdrawals of principal are not includible as income.

Why annuity maximization works

Instead of getting the deferred annuity at your death, your beneficiaries receive the life insurance proceeds, income tax free. And you can effectively remove the value of the deferred annuity from your estate by converting it to SPIA. Since the SPIA payments cease at your death. The SPIA is not included as an asset of your estate.

In addition, the life insurance can escape estate taxes if the policy is not part of your estate at death. To achieve this goal, you can't own the policy; it must be owned by another (e.g., your child or an irrevocable life insurance trust). You then make gifts to the policy owner equal to the annual insurance premium. However, gifts may be subject to both federal and state gift taxes, so you should consult your tax professional before making such gifts.

The bottom line

If you own an annuity that you want to transfer to your heirs at your death, a significant portion of its value may be lost to estate and income taxes. Annuity maximization is a strategy that lets you replace part or all of a taxable asset (your deferred annuity) with an asset (permanent life insurance) that may be subject to neither income nor estate taxes at your death. This approach may effectively allow you to increase the amount you pass on to your beneficiaries.