Estate Maximization

Situation

John, 78, and Susan, 80, are successful, retired and currently worth $20 million, $1 million of which is in a deferred annuity with a basis of $200,000. They have four children, maintain a moderate lifestyle and are not consuming all their income. They do not rely on the deferred annuity to meet their lifestyle needs and the deferred annuity could be thought of as an excess asset. They are not currently making annual exclusion gifts to their children.[1]

John and Susan would like to maximize wealth transfer to their family and are concerned about the potential taxation of the deferred annuity at their death. They have heard the deferred annuity may be subject to multiple levels of taxation (income tax and estate tax) and may reduce the value received by their children by up to 70 percent.[2] They are open to the idea of acquiring life insurance outside of their taxable estate provided it can be accomplished without incurring gift tax. John and Susan do not like complex strategies and are looking for an uncomplicated recommendation.

Recommendation

Use the deferred annuity to create an income stream to fund annual premium gifts to an irrevocable life insurance trust (ILIT).[3] John and Susan can accomplish this by converting the deferred annuity into a joint and survivor single premium immediate annuity (SPIA) with a life-only annuity option, and then gifting the after-tax SPIA payments of $50,399 to the trustee of the ILIT annually.[4] This would allow the trustee of the ILIT to purchase a guaranteed survivorship life insurance policy on John and Susan, both preferred non-smokers, in the amount of $3,475,594.[5] Moreover, since a life-only annuity option is used in this approach, the SPIA principal is removed from their estate and no longer subject to transfer taxes at death.

[1] Under Internal Revenue Code (IRC) §2503(b), the gift tax annual exclusion amount is $13,000 per recipient per year (2011) and $26,000 per year if a married couple splits their gifts under IRC §2513(a).

[2] These assets may be subject to Income in the Respect of the Decedent (IRD). IRD is money owed to a decedent at the time of his or her death that would have been included in the decedent's gross income had the decedent lived to collect such sums. IRD is includible in the decedent's gross estate and is subject to estate tax. Not only is IRD taxed for estate-tax purposes, but the estate or beneficiary who receives the IRD will pay income tax in the same manner as the decedent. However, IRC §691(c) allows the recipient of the IRD an income tax deduction for the federal estate tax attributable to the IRD received.

[3] Trusts should be drafted by an attorney familiar with such matters in order to take into account income, gift and estate tax laws (including generation-skipping transfer tax). Failure to do so could result in adverse tax treatment of trust proceeds.

[4] Assumes annual SPIA payout of $72,647 with an exclusion ratio of 12.5 percent.

[5] Guaranteed death benefits are subject to the claims-paying ability of the insurance carrier.

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Benefits

By incorporating life insurance into their wealth transfer planning in such a manner, John and Susan may be able to pass more wealth to their family than would be the case if they retained the deferred annuity until their death. With this approach at their joint life expectancy, John and Susan could increase the amount of wealth transferred to their family by $2,588,455.[6]

POTENTIAL BENEFITS		
	Without Estate Max	With Estate Max
Deferred Annuity in Year 22 (LE)	$2,925,261	$0
Life Insurance Death Benefit	$0	$3,475,594
Estate and Income Tax on Excess Assets	$2,038,122	$0
TOTAL	**$887,139**	**$3,475,594**

[6] Hypothetical case study for illustrative purposes only. Individual results may vary. Case study assumes income tax rate of 35 percent, estate tax rate of 45 percent and 5 percent earnings rate on the deferred annuity. Life expectancy is based on the 2001 Commissioners Standard Ordinary Mortality Table.

Before establishing an ILIT one should consider the cost of creating and maintaining the ILIT, that life insurance qualifications generally require medical and financial underwriting, the desired policy premium may be higher than your gift tax exclusion or lifetime exemption, gifts in excess of these exclusions and exemptions will be taxable, and that transfers to an ILIT are irrevocable.

ILIT assets may be insufficient to pay the premiums. In certain situations additional out of pocket contributions to the ILIT may be required to maintain the desired level of insurance.

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