

# Sales Strategy

## Annuity Maximization



### WEALTH TRANSFER PLANNING WITH ANNUITY MAXIMIZATION

Many of your clients who originally purchased a deferred annuity 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 will 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 assets.

#### DEFERRED ANNUITIES AT DEATH

A deferred annuity is subject to both ordinary income and estate taxes at death. This double taxation can 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.

#### WHAT IS ANNUITY MAXIMIZATION?

Annuity Maximization is simply an asset repositioning strategy in which the annuity is exchanged or converted to a Single Premium Immediate Annuity (SPIA). A SPIA provides an income stream for a chosen number of years based on a single deposit made to purchase the annuity, and your client’s age and health status. Your client may then make gifts of the after-tax income generated from the SPIA to an Irrevocable Life Insurance Trust (ILIT).<sup>1</sup> 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. Alternatively, clients who are unwilling to give up the deferred annuity may, instead, take withdrawals from it to fund the life insurance policy. However, depending on the specific deferred annuity contract, withdrawals may be subject to surrender charges or penalty taxes if taken prior to age 59½. Either way, potentially more can be transferred to heirs, estate and income tax-free, when an Annuity Maximization approach is used.<sup>2</sup>

THE PROBLEM	THE SOLUTION	THE RESULT
Up to 70% of the deferred annuity may be taxed.	<ul style="list-style-type: none"> <li>• Convert deferred annuity to SPIA, or take annuity withdrawals.</li> <li>• Leverage SPIA income or annuity withdrawals with life insurance.</li> </ul>	Increase the amount transferred to heirs.

## WEALTH MAXIMIZATION AND DEFERRED ANNUITIES

**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 2007, this amount is \$12,000 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.

**Conversion.** Converting a deferred annuity to a SPIA can provide a consistent, predictable stream of income to fund an annual program of gifts made to an ILIT. Since the income stream is based on a life-only annuity, your client will not outlive the income.

**Withdrawals.** For clients who are reluctant to exchange the principal of the deferred annuity for the SPIA's guaranteed lifetime income, withdrawals from the deferred annuity can be used to fund the ILIT. Taxes can still be minimized since the value of the deferred annuity in the estate will be reduced by the withdrawals. The remaining annuity balance can be accessed in the case of an emergency, as well. Withdrawals, however, may be subject to surrender charges and/or taxes based on the specific deferred annuity contract.

**Conversion vs. Withdrawals.** Determining which method is best depends entirely on your preference. The risks, benefits, and cost of conversion or withdrawals should be considered before making a decision. Talk with your investment advisor to see which one is best for you.<sup>3</sup>

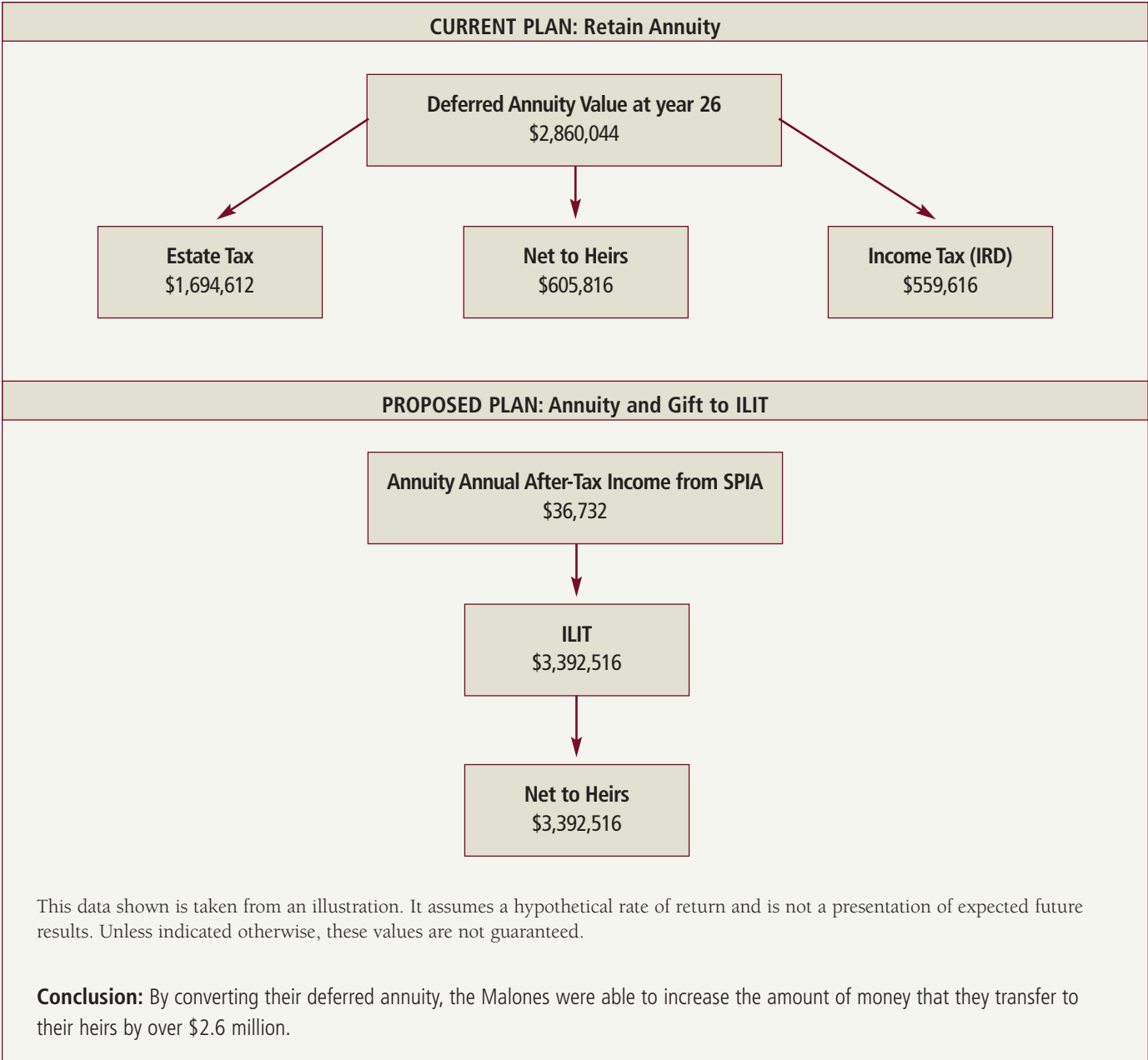
### CASE STUDY: SAM AND MAGGIE MALONE

**Facts:** Sam (67) and Maggie (62) Malone are both non-smoker, preferred risks. They have a \$5 million estate growing at 5% after tax. Included in the estate is a deferred annuity that has a current value of \$750,000 growing at 5.5% with cost basis of \$400,000. Sam and Maggie have three kids and one grandchild, and they recently inherited some money. They need to put an estate plan in place, and they have set up a meeting with their financial advisor.

**Solution:** The financial advisor recommends that they convert to a SPIA and gift the distributions to a trust to fund a life insurance policy inside an ILIT.

**Here is what it looks like:** Sam and Maggie convert their deferred annuity to a SPIA. The net after-tax annual income is \$31,348. They gift this amount annually to the ILIT, which will purchase a John Hancock Protection SUL-G life insurance policy with an initial face amount of \$3,392,516.<sup>4</sup> In this case, Sam and Maggie decided to convert or "annuitize" their deferred annuity, rather than take withdrawals, because the annuity income is greater with the conversion approach.

**The Numbers:** The Malone's financial advisor used the following flow charts to demonstrate the power of wealth maximization.



**SUMMARY**

Using a deferred annuity to leverage annual exclusion gifts is a great way to maximize the amount passed on to heirs. Since an annuity is hit with both income and estate taxes at death, replacing it with a single premium immediate annuity or reducing it through withdrawals today can help your client to create a larger legacy for future generations.



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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 tax). Failure to do so could result in adverse tax treatment of trust proceeds.
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3. Loans and withdrawals will reduce the death benefit and cash surrender value, and may cause the policy to lapse. Lapse or surrender of a policy with a loan may cause the recognition of taxable income. Policies classified as modified endowment contracts may be subject to tax when a loan or withdrawal is made. A federal tax penalty of 10% may also apply if the loan or withdrawal is taken prior to age 59½.
4. This example assumes that the annuity grows at 5.5% after tax, the income tax rate is 35% and the estate tax rate is based on current law.

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