ADVANCED MARKETING BULLETIN

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Using SPIAs for Spendthrift Protection

Single premium immediate annuities (SPIAs) can often be a useful tool to protect against an adult child's potential judgment creditors or poor spending or investment choices.

Most parents would like to give or bequeath financial assets to their children. However, their children may lose or diminish those assets through mismanagement, creditor judgments, divorce, or other unfortunate events. Sometimes, SPIAs are used to meet a parent's objective to provide "spendthrift" protection. This bulletin will focus on the spendthrift strategies for *non-qualified* SPIAs only. A subsequent bulletin will focus on deferred annuities.

Because most immediate annuities have no cash surrender value[1], they often may help achieve spendthrift protection objectives. They are especially useful when a parent wishes to start gifting during his or her lifetime, because payments may begin immediately. A SPIA may be structured to provide spendthrift protection in at least two ways.

First, the parent could own the SPIA and make the child the annuitant, beneficiary, and payee.

- The child receives the annuity payments, but the parent generally maintains ownership rights, including the right to change the beneficiary.
- The parent will pay income taxes on the annuity payments made to the child. The payments may be taxable gifts.[2]
- The child will become the owner of the contract upon the parent's death. Although SPIAs generally have no cash surrender value that the child can access[3], the child will normally have the right to assign the annuity to another person or entity in exchange for money or as security for a loan. To avoid this result, the parent may want to make the contract *non-transferable and non-assignable upon issue*. This feature is accomplished by use of a special contract endorsement.[4]

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Second, the child could be the owner, annuitant, and payee from the original issue date of the SPIA.

- After the parent pays the single premium, the child receives an income stream from the SPIA.
- Depending upon state laws, the child's annuity income may be subject to judgment creditors, divorce settlements, or voluntary assignment. To minimize these possibilities, the parent may condition his or her single premium gift upon the child's application for a contract with non-transferable and non-assignable provisions from the start.
- If the child surrenders the contract during the "free look" period, many insurance companies return the premium payment to the payor of the premium, not the contract owner.[5]
- The child will pay income tax on the annuity payments based upon an exclusion ratio. By making the premium payment, the parent makes a gift of the premium payment to the child.[6]

Conclusion: SPIAs can often meet the spendthrift objectives of a parent for an adult child. The degree to which a parent may wish to exercise control during his or her lifetime and after his or her death differs from case to case. The choice of owner, annuitant, and beneficiary among family members significantly affects spendthrift protection objectives and tax ramifications. Spendthrift protection objectives may not always be consistent with tax planning objectives. Although most states' statutes permit spendthrift clauses for life insurance and annuity settlement options, the specifics of the laws may vary from state to state.

Disclaimer

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[1] Unless the SPIA has a commutation feature.

[2] The payments are also taxable gifts, but may qualify for the annual federal gift tax exclusion ($12,000 per donee in 2006). A married donor can exclude gifts of up to $24,000 a year (2 × $12,000 annual exclusion) to each donee if his spouse consents to the gifts. Gifts in excess of the annual exclusion amount require the filing of a federal gift tax return and may reduce the parent's lifetime federal gift and estate tax credits. Because the parent is the owner of the annuity, the fair market value of the annuity will be included in the parent's taxable estate. The present value of the future annuity payments would be the approximate value for estate tax purposes.

[3] Unless the contract has a commutation feature.

[4] Though a non-transferability feature will also limit the parent's ownership rights, it may provide the greatest spendthrift protection after the parent's death. This option should not be taken lightly. The tax treatment of this ownership arrangement combined with a "non-transferable" endorsement is not entirely clear. Since the owner (Parent) has given up both the income and the transfer rights, one might argue that he or she has made a completed gift to the payee (Child). To our knowledge, the IRS has never ruled on this issue. If this ownership arrangement and the non-transferable endorsement are desired, the prospective owner should obtain independent tax advice or counsel. Importantly, the parent or the parent's legal advisor must review and understand the annuity contract provisions and issue procedures.

[5] The Genworth Financial companies follow this practice for SPIAs.

[6] The gift may qualify for the annual gift tax exclusion ($12,000 per donee in 2006. Gifts in excess of the annual exclusion will require the filing of a gift tax return and possible reductions in the parent's lifetime federal gift and estate tax credits. The contract value will usually not be included in the parent's taxable estate.