Nationwide®
is on your side

The Advanced Consulting Group

White paper

Funding life insurance with a single premium immediate annuity

Steve Hamilton, JD, CLU®, ChFC®
Director, Advanced Consulting Group

Can a life insurance policy be funded with payments from a single premium immediate annuity (SPIA)?

The answer is, yes.

The strategy can provide the certainty of premium payments and an income tax free death benefit as well as other potential benefits. To optimize the use of this strategy, Nationwide has developed guidelines to avoid the potential financial and taxation risks associated with these arrangements. Let's consider the issues we need to be aware of, Nationwide's process, and some of the opportunities.

Caution — Le Gierse case

In an old but still relevant case, Helvering v. Le Gierse, 312 U.S. 531 (1941), it was *held that a life insurance death benefit was subject to income taxes* because it in essence wasn't a "life insurance" death benefit because a lifetime payout SPIA was purchased at the same time as a life insurance policy from the same insurance company.

In LeGierse the insured and annuitant were the same person. So, the court looked at the transactions as one and determined that there was no risk transfer since the life insurance company had offset the risks of longevity and premature death, and therefore there really was no "life insurance".

Opportunity — avoid Le Gierse

While the Le Gierse case is unique and old, there is no reason to test it. It can be avoided in several ways:

1. By using a term certain annuitization payout instead of a life payout on the life of the annuitant, who is also the insured, if the SPIA and life insurance are being purchased from the same insurance company.

2. It also can be avoided by using different insurance companies, one for the SPIA and another for the life insurance.

Making the strategy work at Nationwide

Nationwide has put in place procedures to:

- Allow SPIA distributions to pay for life insurance, and
- Avoid the risk of losing the income tax free treatment of the life insurance death benefit

Nationwide's current guidelines

1. Initial questions:
    a. Will the SPIA payments be used to fund a life policy?
    b. If yes, will they be funding a Nationwide life policy or a non-Nationwide life policy?

The Nationwide SPIA application will capture the intended use of the SPIA payments and includes disclosures regarding the restrictions.

3. Contract Options

3a. Income Options *(Only one Option may be elected and cannot be changed. Nationwide reserves the right to discontinue any Income Option for new Contracts. All Single and Joint Life Options require proof of age for all An[illegible] If funding a life policy, certain Income Options may be restricted.)*

Does not provide a lifetime payout.

☐ Term Certain only [ ] Years [ ] Months

Based on the life of the Annuitant.

☐ Single Life
☐ Single Life with Cash Refund
☐ Single Life with [ ] Years [ ] Months

Survivor payout percentages are 20% - 100%. Only 100% is allowed for Joint and Survivor with Cash Refund/Joint and Last Survivor with Cash Refund.

Payment reduces upon the death of either the Annuitant or the Joint Annuitant.

☐ Joint and [ ]% Last Survivor
☐ Joint and [100%] Last Survivor with Cash Refund *(Beneficiary Required)*
☐ Joint and [ ]% Last Survivor with [ ] Years [ ] Months *(Beneficiary Required)*

2. **Nationwide life policies** — Nationwide life Insurance policies **funded by Nationwide SPIAs** can only be funded with a term certain income option.

3. **Non-Nationwide life policies** — Nationwide SPIAs being used to fund non-Nationwide Life policies have the following restrictions:
    a. For premium amounts under $1 million there are no restrictions.
    b. For premium amounts of $1 million or over, payout options will be limited to:
        i. Any term certain option
        ii. Single/joint life with a 20-year term certain or longer
        iii. No other payment options are available

4. **Payments within Nationwide** — Payments from a Nationwide SPIA can be made directly to a Nationwide life insurance policy. Complete the Payee/Method of Payment section of the SPIA application for direct payment.

Page 4 of 7

Selected frequency applies to all Payees.

3d. Frequency of Payments

I elect *(choose only **one**)*: ☐ Monthly ☐ Quarterly ☐ Semi-Annually ☐ Annually

3e. Payee/Method of Payment *If no Payees are designated, the Payee will be the Owner. If more than one Payee, please complete the Immediate Annuity Payee Administrative Form (in the New Business Enrollment Packet).*

First Name: [ ] MI: [ ] Last Name: [ ]

Allocation (whole % only): [ ]% OR $ [ ]

Date of Birth: [ ] Sex: ☐ M ☐ F Soc. Sec. No. or Tax ID: [ ]

Street: [ ]

City: [ ] State: [ ] ZIP: [ ]

☐ Check to Payee's address above

Will payments from this annuity fund a Nationwide life insurance policy? ☐ **Yes** ☐ **No**

If **YES**, please provide the **Nationwide Policy Number:** [ ]

5. **Nationwide SPIA premium limits** — There are premium limits on Nationwide's SPIAs. For Income Promise Select, individual owners are allowed to invest a total of $3 million, unless Nationwide grants a prior large case exception. *The $3 million limitation is inclusive of all other Nationwide annuities.* Example: Joe Smith owns $2.3 million of Nationwide variable annuities. He can purchase $700,000 of additional annuities.

6. **Nationwide SPIA Liquidity feature** — The liquidity feature is offered on all payout options (except life only) up to $1 million in premium.

Nationwide's requirements and limitations will change when needed to maintain financial soundness and to reduce risks. Please contact your Nationwide wholesaler for information on the current immediate annuity guidelines.

An estate planning strategy

One estate planning strategy encourages clients, "to live wealthy, die poor, and leave their children wealthy". Like many strategies, it looks great on paper but in real life it's not so simple.

How can this be done?

The simple answer is using a lifetime single premium annuity (SPIA) to purchase a life insurance policy held in an irrevocable life insurance trust (ILIT).

How does the strategy work? An exaggerated hypothetical example

Facts and goals
Mr. and Mrs. Hypothetical have an estate worth $15 million. They know that if nothing changes, there will be some federal and state estate taxes. They want to leave their children the full $15 million. They also want financial certainty with a substantial income for the rest of their lives. How can they meet all their goals of living well, paying the government no taxes, and still leave the full value of their estate to the kids?

The "strategy"
They decide to use all $15 million to purchase a single premium immediate annuity (SPIA) that will pay out a fixed amount for as long as one of them is alive. They would be joint annuitants. The payments are guaranteed by the insurance company for as long as one of them is alive giving them a substantial cash flow to live on. At the second death, there is no longer any income left to be paid out and therefore no value in the SPIA. The result is an estate value of zero. They have died broke.

Some of the money from the SPIA payment is used to purchase a second-to-die life insurance policy on Mr. and Mrs. Hypothetical. The money is gifted to an irrevocable life insurance trust (ILIT) that they establish. The trustee uses the gifted money to purchase a $15 million dollar life insurance policy. The life insurance death benefit of $15 million pays to the ILIT at the second death and the trust distributes the $15 million to the children free of taxes.

Hypothetical meets reality — issues that need to be considered

Hypothetical examples are exactly that, "hypothetical". Real life, with real people, may not work so smoothly. In addition to the issues raised by the Le Gierse case and the procedures, like Nationwide's, that are in place at many different companies consider some of the other realities:

- Underwriting - With life insurance, you have issues of physical and financial underwriting that may not allow the Hypotheticals to acquire the amount of life insurance they want or at the cost that makes financial sense.

- Gifting and Expenses - The size of the gifts to the ILIT may create a gift tax situation. There will also be a cost to set up the trust and to administer it.

- Practicality and advisability - The Hypotheticals may have tax, financial, and personal reasons for not cashing out all their property to purchase the SPIA. In fact, it would not be desirable to put everything

into a SPIA; leaving nothing for emergencies or unforeseen needs. It's also possible that they may not spend all the money they receive from the SPIA. Whatever property they keep or money they don't spend will be part of their estate.

- Insurance company limits - They also may not be able to purchase a $15 million SPIA since insurance companies have limits on how much obligation they are willing to take on.

What about IRAs or nonqualified deferred annuities?
For individuals with sufficient assets, they are often interested in ways of leaving money to their heirs in tax efficient ways. Life insurance death benefits are often attractive since they are usually paid income tax free and often have a degree of creditor protection in many states. Clients may have significant gains in their deferred annuities or have 100% taxable qualified retirement money, usually in an IRA. While they are not forced to take distributions from deferred annuities at 70 ½ they are forced to begin required minimum distributions (RMDs) from their IRAs.

Opportunity — trading taxable income for an income tax free death benefit
Use a SPIA to provide a predictable cash flow from a nonqualified annuity or IRA to fund a life insurance policy.

Hypothetical example with an IRA — Bringing the strategy closer to real life and more people

Facts and goals
John Smith is 71 years old and has $100,000 IRA. Even though he doesn't need the money and wants to leave it to his grandchildren, he had to take his first RMD of $3,774. He knows that the factor used to determine RMDs will continue to calculate an increasing amount of RMD relative to his IRA balance every year. John doesn't have an estate tax issue.

Strategy
John purchases a $100,000 guaranteed life time UL with the death benefit payable to his grandchildren.

- John is in good health, so his underwriting class is preferred nontobacco.
- Premiums will be $358 a month for 20 years.
- At the same time John purchases a 20-year term certain SPIA IRA with his $100,000 IRA. The 20 years doesn't exceed his IRS Uniform Lifetime Table expectancy.
- The SPIA payments will satisfy his RMDs.
- He will use the $523 monthly SPIA payouts to pay the $358 monthly premium.
- He will withhold the difference between the SPIA payout and the monthly life insurance premium to help cover the income taxes on the IRA distributions.

Results
At John's passing, if it is before the 20-year term certain payments are completed, the remaining payments will be paid to the beneficiary named on the SPIA for the lesser of the remainder of the 20-year term or recalculated to be fully paid out in 10 years.[i] The $100,000 life insurance death benefit will be paid to named beneficiaries, his grandchildren, income tax free.

Summary

When properly done, using a SPIA to pay for life insurance can be a viable solution for clients who want:

- The certainty of premium payments provided by a SPIA and
- An income tax free death benefit from life insurance for those they care about.

Using Nationwide's SPIA and life insurance together provides the efficiency of having the SPIA payments paid directly to the life insurance.

Important reminders – *Before implementing this strategy, be sure to consult with your Nationwide wholesaler about the current limits and requirements. As previously noted, Nationwide's requirements and limitations will change when needed to maintain financial soundness and to reduce risks. Please keep in mind that you cannot 1035 exchange an annuity or annuity payments into life insurance and that 1035 exchange rules are not applicable to IRAs.*

FOR FINANCIAL OR INSURANCE PROFESSIONAL USE ONLY

This material is not a recommendation to buy, sell, hold or roll over any asset, adopt an investment strategy, retain a specific investment manager or use a particular account type. It does not take into account the specific investment objectives, tax and financial condition or particular needs of any specific person. Investors should work with their financial professional to discuss their specific situation.

Federal income tax laws are complex and subject to change. The information in this memorandum is based on current interpretations of the law and is not guaranteed. Neither Nationwide, nor its employees, its agents, brokers or registered representatives gives legal or tax advice.

NFM-15751AO.3 (05/20)

[i] Read the SECURE Act for specific IRA beneficiary options