Advanced Markets ESSENTIALS

Fundamental Information on Advanced Markets Concepts

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What We Do | Aviva's Advanced Markets Team

Our Advanced Markets team provides personal sales assistance for your high-net-worth clients and business prospects. We can help you identify individual, business and estate planning needs, assist with traditional advanced markets issues as well as develop innovative, custom-tailored solutions for your challenging advanced sales situations.

We commonly offer assistance on the following topics:

- Business Succession Planning
- Estate Planning
- Irrevocable Life Insurance Trusts
- Retirement Distribution Planning
- Split Dollar / Private Financing Analysis
- Gifting
- Income Tax Planning
- Key Person Planning
- Charitable Trust Planning
- Premium Financing Plans
- Client Presentations
- Deferred Compensation / SERP Proposals
- Miscellaneous Wealth Transfer Issues

Within the Advanced Markets Resource Center on the Aviva Live webpage you'll find:

- Impact Technologies – free estate planning and wealth transfer software.
- "The Compass" – a monthly newsletter by Aviva's Advanced Markets team that focuses on sales ideas and concepts.
- "Case Closed: Success Stories from the Field" – a quarterly newsletter featuring the concept and design of "real life" case studies.
- Advanced Markets' Agent and Advisor Guides, financial calculators, specimen documents, Advanced Markets webcasts, Advanced Markets self-study materials.

Also in the Advanced Markets Resource Center, access to our comprehensive Sales Concept Kits that include a variety of agent and consumer approved materials, on the following subjects:

- Business Continuation
- Charitable Giving
- Nonqualified Executive Benefits
- Split Dollar
- Key Person Coverage
- Estate Planning
- Executive Bonus
- LIF PRO
- Roth IRAs
- Simplified Issue/Guaranteed Issue

Access valuable services and tools we make available exclusively to our agents in the advanced planning area. **www.avivausa.com/agents**

Advanced Markets ESSENTIALS

Contents

Charitable Giving through Life Insurance 1
Charitable Remainder Trust 2
Cross Purchase Buy-Sell 4
Employer Endorsement 5
Estate Planning 6
Executive Bonus 8
Executive Bonus Plan 9
Flexible ILIT 11
Golden Executive Bonus Arrangement 12
GRAT 13
IDIT 14
ILIT Guide 15
IRA Maximization 16
Key Person 17
Nonqualified Deferred Compensation 18
Reducing Transfer Taxes Through Discounting 20
Restricted Executive Bonus 21
S-Corp Redemption Buy-Sell 22
Self Canceling Installment Note 24
Stock Redemption Buy-Sell 25
Stretch IRA 27
Traditional IRA, Roth IRA 29
Wealth Maximization 31
2011 Tax & Section 415 information 32

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Charitable Giving through Life Insurance

Charitable giving programs can be funded in a number of ways, but none offer the unique advantages and the flexibility of life insurance. Typically, the amount of a policy's death benefit is many times the total of premiums paid, resulting in "leveraged dollars." Instead of your clients making annual donations to help fund their charities' missions, they could leave amounts large enough to have buildings or endowments in their name.

Perhaps more importantly, charitable gifts of life insurance typically avoid or reduce some combination of income, estate, gift, and capital gains taxes.

The following are simple techniques that illustrate the benefits of using life insurance in charitable giving.

1. **GIFTING INSURANCE POLICY DIVIDENDS TO A CHARITY.** If your client has an older dividend-paying whole life insurance contract, this strategy is easy to implement. All the client has to do is contact the insurance company and request the policy dividends to be paid in cash, and then donate those dividends to a charity. These cash gifts can be deductible up to 50 percent of their adjusted gross income.
2. **CHANGE THE CURRENT BENEFICIARY TO A CHARITY.** This technique is also easily established. Your client names a favorite charity as the beneficiary for either the entirety or a portion of the policy proceeds. This allows the client to retain control of the policy as the ownership has not changed and the beneficiary designation is revocable at any time. Your client will not be able to deduct the premiums paid on this policy, but they will receive a full charitable estate tax deduction for the proceeds.
3. **GIVE AN EXISTING POLICY TO A CHARITY.** Do your clients have policies they no longer need? Perhaps a policy was purchased when the children were small, or before the mortgage was paid in full. Your clients may want to consider gifting their older policies to charity. Their estate is effectively reduced by the face amount of the proceeds. In addition, they will generally receive an income tax deduction equal to the lesser of the cost basis or the fair market value of the contract. Caution needs to be exercised when there is a policy loan on the contract and your client should consult their tax advisor and the charity prior to transferring ownership.
4. **BUY A NEW POLICY FOR THE CHARITY.** This can provide a very large gift in proportion to the amount of the premiums gifted to the charity. The premiums should provide current tax deductions as long as there are "no strings" attached to the gifts and the charity possesses all ownership rights in the contract.
5. **BUY LIFE INSURANCE TO REPLACE THE VALUE OF AN ASSET DONATED TO CHARITY.** Your clients may be in position to donate highly appreciated assets to charity, but the concern about their children's and grandchildren's future well-being may be holding them back. To overcome this, your clients can replace the value of assets with life insurance so their heirs can receive inheritance income tax free. If the policy is purchased inside a wealth replacement trust, the death benefit can also be estate tax free.
6. **BUY LIFE INSURANCE TO BACK A PLEDGE OR FUTURE DONATION TO CHARITY.** Pledging a large amount to a hospital can mean a lot to your client. The best way to fund a future donation or pledge is by purchasing life insurance and naming that charity as the beneficiary. Life insurance provides a low-cost way to provide a large benefit to charity. As the pledge is paid off, your client can decide whether to leave the charity as beneficiary of the entire life policy, or redirect a portion of the proceeds to their heirs or another charity.

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Charitable Remainder Trust

Do your clients have highly appreciated assets, such as stock or real estate, in their portfolios?

Would your clients like to increase their income and reduce current income taxes at the same time?

Do you have clients who want to maximize their estates for their heirs and leave substantial gifts to their favorite charities?

If so, you owe it to your clients to check out the benefits of a Charitable Remainder Trust (CRT).

What is a Charitable Remainder Trust (CRT)?

The Tax Reform Act of 1969 created the Charitable Remainder Trust, an irrevocable tax-exempt trust available in annuity or unitrust formats. Generally, a partial interest gift to a charitable organization does not qualify for the income, gift, or estate tax deduction. A CRT is an important exception to this "partial interest rule."

To establish a CRT, a donor transfers property to the trust and receives an income tax deduction equal to the asset's fair market value minus the present value of the stream of payments the income beneficiary is to receive from the trust. The interest rate used to determine the present value is the Internal Revenue Code Section 7520 Interest Rate. This rate changes monthly, however the donor has the option to use the current month's rate or one of the previous two month's rates. A higher rate creates a higher income tax deduction.

The income beneficiary can receive income in the form of an annuity or unitrust. When income is distributed, it must be classified according to a four-tiered taxation system. For tax purposes, trust distributions must be made in the following order:

1. Ordinary Income
2. Capital gain
3. "Other income"
4. Principal

Charitable Intent

A Charitable Remainder Trust is a great planning tool if – and only if – your client has charitable intent. Maybe they are passionate about their church, alma mater, or a cause such as breast cancer research. Charitable intent is necessary because CRT rules require that the present value of the remainder interest be at least 10 percent of the fair market value of the assets transferred to the trust. If $1 million is transferred to the trust, the present value to the charity must be a minimum of $100,000. When an asset is transferred to a CRT, the donor avoids current tax on the gain inherent in the asset and the CRT pays no tax when the asset is sold. This is a very valuable advantage to a CRT, however clients should not use this technique just for tax advantages. Tax advantages combined with charitable intent are what make the CRT a great planning tool.

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17406 3/11

Charitable Remainder Annuity Trust (CRAT)

When a CRAT is used, the trustee is required to pay a specified annual annuity to the donor or other designated individuals for a certain period of time. The amount of the annuity must equal at least 5 percent and not be greater than 50 percent. The 10 percent required remainder interest is determined at the time the asset is transferred. Additionally, there must be a 95 percent probability that the charity will receive the 10 percent remainder. The CRAT's income beneficiary must receive the required annuity payout each year regardless of the return inside the trust. This will sometimes require principal to be invaded.

Charitable Remainder Unitrust (CRUT)

When a CRUT is used the trustee is required to pay income beneficiaries a specified percentage of the value of the trust assets each year. The trust's assets are revalued each year. If the value increases, the payout increases; if the value decreases, the payout will decrease accordingly. As with the CRAT, the specified percentage of the CRUT must equal at least 5 percent and be no greater than 50 percent. The value of the charitable remainder must be at least 10 percent of the net fair market value of all assets transferred to the trust. One key advantage of the CRUT is the ability to add assets to the trust at a future date.

Which Type Of Remainder Trust is Best for Your Client?

The key questions to ask are:

- Do you foresee making additional contributions? Yes = Unitrust
- Are you willing to tolerate fluctuating income? No = Annuity Trust

Watch Out for These Circumstances

Caution should exercised if a client is interested in leaving the remainder interest to a private foundation. In this situation, the charitable deduction could be limited to the cost of the asset contributed. The type of asset can also change the percentage limitation.

Special care must also be taken when assets have debt associated with them. This could create taxation to the trust and donor, plus the trust could lose the charitable classification.

Finally, be careful if the sale of the asset already seems likely. If an agreement is already in place, the donor would be required to recognize the capital gain, losing one of the key advantages of the CRT.

Wealth Replacement Trust

Many times potential donors to a Charitable Remainder Trust are reluctant to give substantial assets away because of their concern for their heirs. One way to overcome this reluctance is to replace the asset with life insurance in an irrevocable life insurance trust. When done correctly, the life insurance can be income and estate tax-free to the heirs. Many times this will increase the net amount passed to heirs after tax. The combination of the tax deductions and cash flow from the CRT are usually more than enough to fund the wealth replacement life insurance policy.

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Cross Purchase Buy-Sell

Buy/sell planning is a critical element of any successful business

- It provides a definite market for transferring the ownership interest. The co-owners or business entity must purchase the interest
- It specifies a set or determinable price. This price may also set the value used for estate tax calculation
- It provides some or all of the funds necessary to execute the agreement – when properly funded with life insurance.
- It maintains "closeness" of the business by restricting and planning who/what can receive the business interests
- It provides liquidity to pay estate taxes (due 9 months from date of death)
- It makes the entity a better credit risk because of the probability of business continuing past an owner's death

All businesses can benefit from buy-sell planning – sole proprietorship, C Corporation, S Corporation, Partnerships, LLCs, etc.

How cross-purchase works:

1. At an owner's death, disability or departure, the surviving/remaining owners agree to purchase the business interest – this is documented in a formal agreement between/among the owners.
2. Each business owner applies for (and is beneficiary of) a life insurance policy on every other owner
3. At death, each surviving owner receives the policy death proceeds.

   If departure is for reasons other than death (i.e. disability) the policy's cash values can be accessed to partially or totally fund the purchase.
4. Each surviving owner purchases the agreed business interest from the decedent's estate (e.g. if only one surviving shareholder, he/she purchases all of the business interest from the estate).

Results:

Estate's non-liquid asset (i.e. the business interest) is sold to the remaining owners at an agreed upon price (little or no gain should be taxable due to step-up in basis at date of death.

The business interest passes to those intended to receive that interest.

Surviving owners receive basis in the acquired interest equal to the price paid (step-up in basis).

Why life insurance:

Cash value inside a policy grows tax-free (tax-deferred if withdrawals exceed policy basis).

Death proceeds are received income-tax free and received at just the right time to fulfill the agreement.

Individually owned policies are generally not subject to the business' creditors.

Disadvantages:

Business owner uses personal funds to pay premiums on the policy they own. A split-dollar (loan arrangement or employer endorsement) arrangement can be implemented to assist in paying premiums.

Possible disproportional premium payments – the younger/healthier owners will pay more in premiums to insure the older/less-healthy owners

Policies are potentially subject to the individual's creditors.

Administratively complex – the more business owners the more policies that must be purchased and maintained. For example: if there are three owners, each owner will own and maintain two policies (6 policies total) – if there are six owners, each owner will own and maintain 5 policies (30 policies total).

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17092 3/11

Employer Endorsement (Split Dollar Economic Benefit)

Employer Endorsement

Employer and employee enter into an endorsement split-dollar agreement.

Employer owns the policy (or is the deemed owner of the policy), pays the premiums, has access to all policy values, and gives the employee the right to designate the beneficiary for a specified amount of death benefit.

The employer can be the "deemed owner" for tax purposes even though the employee (or employee's trust) is the actual owner, if the actual owner (trust) collaterally assigns all rights in the policy (except specified death benefit) to the employer (a non-equity, collateral assignment). This is a useful technique for estate planning purposes where the economic benefit costs are less than entering into a loan arrangement and the policy is owned by an ILIT to avoid "incidents of ownership" issues.

IRC §101(j) requirements of "notice and consent" paperwork should be completed.

The employee has annual compensation income equal to the "economic benefit" provided by designating the beneficiary.

The cost per thousand for a joint/survivor arrangement (2nd to die policy) is typically very low.

The economic benefit is determined by an IRS table (currently Table 2001) that gives a cost per thousand for the death benefit provided based on the insured's age during the year.

Advantages:

- Provides a "golden handcuff" – if the Executive leaves employment, the Employer can terminate the endorsement.
- Employer maintains control over the policy.
- Is cost-neutral for the employer. Costs are recovered through death proceeds.
- Provides needed life insurance coverage to an executive at a reasonable cost.
- Can be used in estate planning to reduce transfer tax costs associated with funding the irrevocable trust (ILIT).

Notes:

Endorsement Split-Dollar is a Welfare Benefit Plan for ERISA purposes and requirements.

An Endorsement arrangement is not appropriate for Public Company executives due to Sarbanes-Oxley implications.

Many employers are seeking ways to reward and retain their top employees. Providing a meaningful life insurance benefit can mean the difference between keeping the key employee's loyalty or loosing him or her to the competition. Employer Endorsement may be the strategy for this objective.

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Estate Planning

Estate planning consists of:

- Accumulating information on client's current/ future assets;
- Projecting the asset value based on (1) client's current planning and (2) assumed growth rate to a future date – assumed date of death;
- Applying assumed estate tax law to determine client's potential estate tax liability;
- Suggesting appropriate planning techniques that potentially reduce future client estate tax liability; and
- Re-projecting client's potential estate tax liability based on alternative planning.

  Gifting is a major part of estate planning for (1) reducing the size of the estate; and (2) funding the irrevocable trust (ILIT) so life insurance premiums can be paid

- Clients can each gift $13,000 in 2011 (annual exclusion indexed for inflation) to an unlimited number of individuals. Gifting removes the asset from client's estate and also removes the appreciation associated with the asset. Gifting techniques include: outright gift of cash; gifting business units at a discount for "lack of marketability" and "lack of control"; grantor retained annuity trusts (GRATs); (sale to intentionally defective grantor trust (IDITs); etc.
- Gifts to an ILIT are considered a gift of a future interest because the ILIT beneficiary cannot currently use the gift. The annual exclusion does not cover a future interest gift. Therefore, the ILIT trustee must give the beneficiary a right to withdraw the gifted funds for a period of time (usually 30 days) – a "Crummey Notice." Once the period for withdrawal has lapsed, the trustee can use the funds to pay premiums.
- If the premium is larger than the available annual exclusions, or if the annual exclusions are being used with other planning, then the client should consider implementing a premium sharing arrangement (endorsement split-dollar, employer loans, private loans) or a premium financing arrangement. Premium sharing arrangements are essentially a process of "renting" the death benefit (endorsement arrangements) or borrowing to pay premiums (loan arrangements). The effect is to reduce the annual gift tax cost from the entire premium cost for the year to either: (1) the "economic benefit" (endorsement arrangement) or (2) the "interest" (loan arrangement) cost of the arrangement. It is important to have a take-out strategy for any premium sharing arrangement. Such strategies can include: using policy values; GRAT; IDIT; charitable remainder trust; etc.
- If the required annual premium is $100,000, the ILIT trustee could borrow the funds from the lender (private or commercial) with the result being the annual gift for transfer tax purposes is reduced from the $100,000 to the interest on the outstanding balance.
- Transfers of a certain total value are allowed free of any estate and/or gift taxes. These tax-free transfers are in addition to those made under the gift tax annual exclusion, those made to a spouse, or those made to charity. This tax benefit is commonly expressed in terms of the value of the transfer (during life and at death) that it shields from tax (this is known as the application exclusion amount (or unified credit) ($5,000,000 in 2011 and 2012, then $1,000,000 thereafter). Individuals may use their applicable exclusion amount during life and any amount not used is available at death. This amount will be decreased to $1,000,000 beginning in 2013 and beyond.

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- Portability: During 2011 and 2012, any amount of the $5,000,000 applicable exclusion not used by the deceased spouse can be used by the surviving spouse during life and/or at death. Portability does not apply to generation-skipping transfers (GST) and is repealed on 12/31/2012 unless extended by new tax law.

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Executive Bonus

Executive bonus is the simplest of the executive benefit plans. In an effort to recruit, reward and/ or retain top talent, the employer agrees to pay the premiums on a life insurance policy owned by the executive. This amount is includible in the executive's compensation and is generally deductible to the employer (it would not be deductible to the extent that his or her compensation is not "reasonable" per IRC 162, or owners of an S Corporation).

This policy is under the complete control of the executive and the employer has no interest in the policy. The executive can change the beneficiary, take a withdrawal from the policy, take a loan against the policy, collaterally assign the policy, and may consider transferring the policy to an irrevocable trust (ILIT) for estate planning purposes. If the policy is transferred to an ILIT, the transfer will have gift tax and three year inclusion implications, and transfer for value implications. All implications can be adequately handled with proper planning. If the executive can make cash gifts to the ILIT using his/her annual exclusions, the ILIT is structured as a "grantor trust", and the ILIT trustee purchases the policy from the executive.

The executive bonus arrangement is a "fuzzy" handcuff in that the executive can terminate employment and does not forfeit any rights or benefits in the policy. If a slightly stronger handcuff is desired see "Restricted Executive Bonus" or "Golden Executive Bonus Arrangement" (GEBA). If a complete handcuff is desired see "Employer Loans" or "Employer Endorsement".

Pros	Cons
Simple to understand and administer	Still is not much of a handcuff – Executive is free to leave and take policy
Valuable benefit for Executive	Is classified as a welfare benefit plan for ERISA purposes
Helps recruit, reward, retain	Entire premium amount is included in Executive's – as executive bonus without restriction
Generally deductible to Employer	

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Executive Bonus Plan Sec. 162 Plan

Do you have clients who want:

- to reward key employees?
- to be able to select whom they reward with no discrimination rules?
- a plan where all contributions are tax deductible?
- a plan that is simple to administer and requires no IRS approval to implement or terminate?

If so, an Executive Bonus Plan might be the solution. An Executive Bonus Plan is a method of rewarding selected key employees by paying the premiums on an employee owned life insurance contract.

Benefits to Key Employee

- The key employee owns the life insurance contract, which can be used for survivorship benefits in case of premature death.
- The cash values can be accessed for emergencies or to help supplement retirement.
- If the key employee should leave, the policy is portable and can be funded with personal dollars.

How the Executive Bonus Plan Works

The Employer:

1. Pays the desired amount of life insurance premium
2. Has no ownership rights in the policy on the key person
3. Includes the premium on the employee's W-2
4. Deducts the premium as compensation and an ordinary business expense

The Employee:

1. Purchases a life insurance policy as applicant, owner and insured
2. Pays the income tax on the life insurance premium
3. Takes advantage of the cash value accumulation and death benefit for personal needs

Plan Design:

Typically there are three types of executive bonus plans: single bonus, double bonus and restricted bonus.

- **Single Bonus -** The employer pays a bonus equal to the policy premium. The employee is responsible for the income tax on the bonus. This causes the plan to become contributory, due to the employee paying the required income taxes out of pocket.
- **Double Bonus -** The employer pays a bonus equal to the premium and the required income tax. For example if the premium is $10,000, the total bonus would be $10,000 divided by (1 - the employee's tax bracket). If the employee was assumed to be in the 30 percent bracket, the total bonus would be $10,000 divided by 0.70, or $14,286. There is no out-of-pocket expense to the employee.

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- **Restricted Bonus -** Many times employers are concerned with the employee's complete access to the policy's cash values. If this is the case, a restricted executive bonus plan can be designed to limit the employee's access to policy cash values. This is accomplished by adding an endorsement to the policy that requires the employer's consent before the employee can:

    1. Borrow from the cash value
    2. Surrender the policy
    3. Assign the policy as collateral
    4. Change ownership

These restrictions can be designed to expire at retirement, at a certain age, or a number of years. The employer must never have any ownership rights in the policy. The restriction must be carefully designed not to give the employer any beneficial interest, or the deduction for the premium as a business expense could be denied. The restricted plan can be either a single or double bonus.

Policy Design:

Life insurance policies are extremely flexible in their design. Two primary objectives desired from a life insurance policy are cash accumulation and guaranteed death benefit.

It is possible to maximum fund a contract, within the Internal Revenue Code guidelines for Modified Endowment Contracts, to accumulate significant amounts of cash that may be accessed in a tax favorable manner. This is done with tax-free withdrawals and loans. The cash flow can be used for a number of reasons, such as supplemental retirement income, college funding, or for emergency situations.

If death benefit is the primary objective, it is possible in today's marketplace to design a plan that can guarantee the death benefit for life. You can use a no-lapse guarantee product that would guarantee the death benefit for life, when certain conditions are met, and have the premium stop at retirement or sooner if needed.

Executive Bonus for the Business Owner(s):

In some situations, depending on the business structure, it would be cheaper for income to be taxed to the shareholder rather than the corporation. If this is true, an Executive Bonus Plan can be an excellent planning tool. However if the entity is a "flow through," such as an S Corp., an LLC taxed as a partnership or S Corp., or an LLP, the Executive Bonus Plan would increase the shareholder/employee's W-2 income. This may not be desirable in many situations.

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Flexible ILIT

- An Irrevocable Life Insurance Trust (ILIT) is used to remove the death benefit from the insured's estate for estate tax purposes. If the insured has an "incident of ownership" in the life insurance policy at death (or within 3 years prior to death) the death benefit value is brought into the insured's gross estate (the designated beneficiaries will receive the actual proceeds but the amount of those proceeds will be included in the insured's gross estate value).
- An "incident of ownership" includes, but is not limited to:
  - the right to change the beneficiary; the right to surrender the policy; the right to take policy loans; the right to assign the policy; the right to revoke a previous assignment; the right to pledge the policy as collateral; the right to receive disability income that reduces the policy death benefit.
  - paying premiums is not an incident of ownership. However, there are potential gift taxes associated with paying premiums on a life insurance policy that is not owned by the premium payor.
- The client (grantor/insured) creates an irrevocable trust then transfers any life insurance policies owned to the trust and/or gifts funds to the trust sufficient to pay premiums. There are gift tax issues associated with gifting life insurance policies and/or cash to an irrevocable trust.
  - The gift tax associated with transferring a policy is (1) total premiums paid – newly issued policy; (2) cost of a comparable policy with insured's attained age – paid up or single premium policy; or (3) the "interpolated terminal reserve" plus unearned premium – previously issued policy still in premium paying status.
  - Transferring cash to an irrevocable trust is considered a "future interest" gift and therefore the annual exclusion ($13,000 for 2011) is not available. It is a "future interest" gift because the trust's beneficiaries cannot currently access and use the gift. However, the gift can be made a "present interest" gift by giving some or all of the trust's beneficiaries a temporary right to withdrawal some of the entire gift.
  - The trustee sends information (Crummey notice) to the beneficiary notifying him/her of the temporary right to withdrawal funds from the trust. If the beneficiary does not exercise his/her right to withdrawal those funds within the stated period (usually 30 – 45 days) then the right "lapses". Once the withdrawal right lapses, the trustee can then use the gifted funds to pay premiums and the gift is considered a "present interest" gift.
- At the insured's death, the trust should receive income-tax-free and estate-tax-free death benefit proceeds. These proceeds can be used for estate liquidity to pay estate taxes (i.e. make loans to decedent's estate or purchase assets from decedent's estate).
- ILITs can be designed with certain provisions or funded in certain ways that allow flexibility. These provisions include:
  - Giving the client's (grantor's/insured's) spouse a withdrawal power limited to $5,000 or 5% of the trust's principal
  - Giving the client's spouse rights to annual distributions of trust income
  - Giving the client's spouse rights to discretionary distributions (if spouse is not trustee); or for distributions for health, education, maintenance and support (if spouse is trustee)
  - Funding through private demand loan

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Golden Executive Bonus Arrangement

A golden executive bonus arrangement is identical to the Restricted Executive Bonus plan in that it restricts the executive's ability to access the policy's cash value for a period of time plus adds an employment contract. The employment contract details the relationship of the executive to the employer and gives the terms of the GEBA. If the executive violates the employment contract (i.e. quits), the employer can sue the executive to recoup the GEBA costs. This does not amount to a forfeiture of the policy values but does give the employer an option to collect the costs of the plan.

The GEBA is an effort to recruit, reward and/or retain top talent. The employer agrees to pay the premiums on a life insurance policy owned by the executive and the executive agrees to continue working for the employer. The policy's values are not accessible by the executive for a specified period of time. The premium amount is includible in the executive's compensation and is generally deductible to the employer (it would not be deductible to the extent that his or her compensation is not "reasonable" IRC 162).

The policy is under the complete control of the executive with the exception of withdrawing cash value or receiving loans from the policy for a period of time (the restriction period). The employer has no interest in the policy. The executive can change the beneficiary, take a withdrawal from the policy (after the restriction period), take a loan against the policy (after the restriction period), collaterally assign the policy (after the restriction period), and may consider transferring the policy to an irrevocable trust (ILIT) for estate planning purposes. If the policy is transferred to an ILIT, the transfer will have gift tax implications, three year inclusion implications, and transfer for value implications. All implications can be adequately handled with proper planning (e.g. the executive can make cash gifts to the ILIT using his/her annual exclusions, the ILIT is structured as a "grantor trust", and the ILIT trustee purchases the policy from the executive).

This arrangement is slightly more handcuff than the restricted executive bonus in that the executive cannot access policy values for a set period of time without the employer's consent and he/she has obligations under the employment contract. If a slightly weaker handcuff is desired see "Executive Bonus" or "Restricted Executive Bonus". If a complete handcuff is desired see "Employer Loans" or "Employee Endorsement".

Pros	Cons
Simple to understand and administer	Still is not much of a handcuff – Executive is free to leave and take policy
Valuable benefit for Executive	Is classified as a welfare benefit plan for ERISA purposes
Helps recruit, reward, retain – a slightly compensation stronger handcuff than executive bonus without restriction	Entire premium amount is included in Executive's – as opposed to premium sharing arrange
Generally deductible to Employer	

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GRAT

- A Grantor Retained Annuity Trust (GRAT) is often used when transferring highly appreciating or income producing assets to subsequent generations. It is also effective in planning to terminate premium financing of life insurance, private financing of life insurance, and economic benefit arrangements.
- The client (grantor) creates an irrevocable trust, transfers highly appreciating or income producing assets to the trust, and retains the right to an annuity payment for a specified term (or for the shorter of a specified term or life).
- The assets remaining in the trust automatically go to the beneficiary after the annuity period is finished. The assets remaining will consist of the assets originally transferred to the trust plus the appreciation on those assets plus the income produced by those assets minus the annuity paid to the grantor.
- Transfer taxes:
  - Any gift tax implications are determined at transfer date.
  - The gift tax value is determined by subtracting the "present value" (PV) of the annuity interest retained by the grantor from the assets' value at transfer date.
  - If the grantor and beneficiary of the trust are unrelated parties, then the annuity is valued using the §7520 rate in effect at transfer date and subtracting from the asset's total value.
  - If the grantor and beneficiary are related, then the §2702 rules may apply. If §2702 applies, then the PV of the annuity interest is valued at zero – thus the gift tax value is the full value of the transferred assets. However, the §2702 valuation rules will not apply if the retained annuity interest is a "qualified interest". A qualified interest includes:
- The right to receive a fixed dollar amount at least annually (qualified annuity interest);
- The right to receive at least annually a fixed percentage of the annually determined fair market value of the assets (qualified unitrust interest); and
- A noncontingent remainder interest following a qualified annuity or unitrust interest (qualified remainder interest).
  - The grantor cannot use his/her annual exclusion amount ($13,000 for 2011) to shield any gift tax consequences associated with a GRAT because the beneficiary has a "future" not "current" right to the asset.
  - The trust should be considered a "grantor trust" for INCOME tax purposes. This means that any income tax consequences experienced by the trust will pass through to the grantor.
- "Zeroed-Out" or Walton GRAT
  - The IRS acquiesced that a client can establish a "zeroed-out" or nearly "zeroed-out" GRAT. This essentially means that a client can establish a GRAT, fund the GRAT, and elect an annuity interest with a present value equaling the initial asset value – thus all income and appreciation from the asset above the required annuity payments is passed free from gift tax consequences.
- If the grantor does not survive the term of the GRAT, the GRAT assets (or at least a portion of the assets) will be included in his/her estate for ESTATE TAX purposes.
  - A life insurance policy may be good additional planning to cover the estate tax caused by inclusion.

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17117

3/11

IDIT

- An Installment Sale to an Intentionally Defective Trust (IDIT) is often used when transferring highly appreciating or income producing assets to subsequent generations. It is also effective in planning to terminate premium financing of life insurance, private financing of life insurance, and economic benefit arrangements.
- The client sells assets to an IDIT in exchange for an installment note payable over a specified period of time.
- The assets sold to the IDIT will hopefully provide sufficient income to cover the debt service. Any excess income can be added to trust principal or expended for other uses (i.e. paying premiums).
- The assets remaining in the trust can remain in the trust or go to the beneficiary after the note is repaid.
- The IDIT is structured as a "grantor trust":
  - No capital gain is recognized by the seller upon transfer of the assets;
  - The IDIT assumes the seller's basis in the property sold;
  - The income or gain generated inside the IDIT is taxable to the client (lender) even though it is not distributed to the client (lender); and
  - The interest received on the note is neither taxable nor deductible.
- The IDIT must be "seeded" or otherwise made a viable borrower – adequate "seeding" may be between 10% and 20% of the value of property sold.
- The note must bear an adequate rate of interest based on the note's duration – based on the applicable federal rate (short-term, mid-term, or long-term).
- If the seller does not survive the term of the IDIT, the remaining balance on the note is included in his/her estate for ESTATE TAX purposes.
  - A life insurance policy may be good additional planning to cover the estate tax caused by inclusion.
- There are no gift tax concerns regarding the sale as long as the note bears an adequate rate of interest.
- There are gift tax concerns if the IDIT must be seeded by gifting funds. However, these can be made subject to the grantor's annual exclusions ($13,000 for 2011) if property structured.
- The sale could be structured to cancel any outstanding balance of the note at the seller's death by using a Self-Canceling Installment Note (SCIN). The adequate rate of interest will be adjusted.

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ILIT Guide

An Irrevocable Life Insurance Trust (ILIT) is used to remove the death benefit from the insured's estate for estate tax purposes. If the insured has an "incident of ownership" in the life insurance policy at death (or within 3 years prior to death) the death benefit value is brought into the insured's gross estate (the designated beneficiaries will receive the actual proceeds but the amount of those proceeds will be included in the insured's gross estate value).

An "incident of ownership" includes, but is not limited to:

- the right to change the beneficiary; the right to surrender the policy; the right to take policy loans; the right to assign the policy; the right to revoke a previous assignment; the right to pledge the policy as collateral; the right to receive disability income that reduces the policy death benefit.
- paying premiums is not an incident of ownership. However, there are gift taxes associated with paying premiums on a life insurance policy that is not owned by the premium payor.

The client (grantor/insured) creates an irrevocable trust then transfers any life insurance policies owned to the trust and/or gifts funds to the trust sufficient to pay premiums. There are gift tax issues associated with gifting life insurance policies and/or cash to an irrevocable trust.

- The gift tax associated with transferring a policy is (1) total premiums paid – newly issued policy; (2) cost of a comparable policy with insured's attained age – paid up or single premium policy; or (3) the "interpolated terminal reserve" plus unearned premium – previously issued policy still in premium paying status.
- Transferring cash to an irrevocable trust is considered a "future interest" gift and therefore the annual exclusion ($13,000 for 2011) is not available. It is a "future interest" gift because the trust's beneficiaries cannot currently access and use the gift. However, the gift can be made a "present interest" gift by giving some or all of the trust's beneficiaries a temporary right to withdrawal some or the entire gift.
- The trustee sends information (Crummey notice) to the beneficiary notifying him/her of the temporary right to withdrawal funds from the trust. If the beneficiary does not exercise his/her right to withdrawal those funds within the stated period (usually 30 – 45 days) then the right "lapses". Once the withdrawal right lapses, the trustee can then use the gifted funds to pay premiums and the gift is considered a "present interest" gift.

At the insured's death, the trust should receive income-tax-free and estate-tax-free death benefit proceeds. These proceeds can be used for estate liquidity to pay estate taxes (i.e. make loans to decedent's estate or purchase assets from decedent's estate).

ILITs can be designed with certain provisions or funded in certain ways that allow flexibility. These provisions include:

- Giving the client's (grantor's/insured's) spouse a withdrawal power limited to $5,000 or 5% of the trust's principal
- Giving the client's spouse rights to annual distributions of trust income
- Giving the client's spouse rights to discretionary distributions for health, education, maintenance and support
- Funding through private demand loan

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17098
3/11

IRA Maximization

IRA Max is an estate planning technique for transferring the value in an IRA into a more transfer tax efficient arrangement (an ILIT and life policy).

The appropriate IRA Max prospect is a client with a large IRA that will not need those funds to support his/her retirement.

Taxation:

- IRAs owned at death are subject to estate inclusion thus increasing any estate taxes owed.
- IRAs do not receive a "stepped up basis" at death.
  - Amounts received by the decedent's beneficiary are taxable as ordinary income (income in respect of a decedent) - the same as if the decedent had received the distribution.

The Process

1. Client establishes an irrevocable life insurance trust (ILIT) that applies for and is beneficiary of a policy insuring client(s).
2. Client takes distributions from the IRA.
3. Distributions may be subject to a 10% penalty unless an exception exists. Exceptions are (IRC § 72(t):
   a. Client is age 59½ or older
   b. Client is disabled
   c. Distribution is part of a series of substantially equal periodic payments
4. Client pays income tax on distribution received.
5. Client gifts remaining distribution to ILIT. ILIT Trustee sends out Crummey notices to make the gifts a "present interest" allowing client to use annual exclusions.
6. Trustee pays premiums on life insurance policy.
7. At client's/insured's death, Trustee collects policy proceeds that are free from income and estate taxes.

Advantages:

- Unneeded IRA's value is transferred to the next generation (or subsequent generations) in a tax-efficient manner.
- Eliminates or reduces estate and income taxes associated with owning an IRA at death and subsequent distributions from that IRA.
- Can provide for an orderly distribution or retention of ILIT assets.

Bottom line:

IRA Max can be an effective way for your client to minimize estate and income taxes associated with owning an unneeded IRA and maximize the amount of wealth transferred to subsequent generations.

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Key Person

Loss of a key person can adversely affect the business' earning potential and will cause expenses related to finding his/her replacement. Typical losses associated with losing a key employee include:

- Loss of management experience and leadership;
- Loss and disruption in production;
- Loss of credit rating for business; and
- Loss of capital that is now required to find a replacement.

Closely held businesses are particularly at risk since there are typically one or two people whose skill and contacts make the business profitable.

How it works:

1. The business purchases a key employee life insurance policy on the key employee. The business is owner and beneficiary of the policy.
2. The business makes non-deductible premium payments.
3. Cash values inside the policy grow tax-free.
4. If key employee dies, the business will receive income tax free death proceeds.

Note: In order for the death proceeds to receive income-tax free treatment, the Pension Protection Act of 2006 requires two items are met:

a. The notice and consent requirements are met; and
b. The insured is a key person or the ultimate payee (not beneficiary) is:

i. A member of the insured's family;
ii. The designated beneficiary (other than employer);
iii. A trust established for the benefit of any such person; or
iv. The insured's estate.

A key person is defined as:

An employee at any time during the 12-month period before the insured's death

who is (at the time the policy is issued):

A director;

A highly compensated employee within the meaning of IRC 414(q) ($110,000 in 2011); or

A highly compensated individual within the meaning of IRC 105(h)(5), except that "35 percent" shall be substituted for "25 percent" in subparagraph (c) thereof (an officer, a 10% owner, or in the highest 35% paid bracket)

Advantages

Business receives needed funds at key employee's death. These funds can be used to offset production declines, bolster the business' credit rating, and find the key employee's replacement.

Business can access the policy's cash value if necessary.

When properly structured, the death proceeds will be received income tax free.

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17097

3/11

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AVIVA

Nonqualified Deferred Compensation

Are your clients looking for creative ways to attract, retain, motivate and reward key employees?

Would they be interested in implementing a plan to defer compensation and the tax on that compensation to a later date?

If so, a nonqualified deferred compensation plan might be the answer.

A well-designed nonqualified deferred compensation plan empowers a business owner to recruit, reward and retain key employees by extending to them financial benefits and incentives.

In addition, a business structured as a C corporation can design a nonqualified deferred compensation plan to allow the owners to defer compensation to a later date, when more advantageous. If a business is structured as a partnership, an LLC taxed as a partnership, or a corporation taxed under Subchapter S, an owner-employee or controlling shareholder generally will not benefit from a nonqualified deferred compensation plan.

What is a Nonqualified Deferred Compensation Arrangement?

The arrangement is a contractual promise between the employer and a select employee or a group of highly compensated employees. The agreement specifies when and under what circumstances future compensation is paid. When done properly, the participant or their heirs will be able to postpone federal income tax on the amounts until the benefits are paid. The promised amounts can be stated as a specific amount, ("defined benefit"); or as an account balance that is growing at a specified rate, ("defined contribution"). Either way, it is critical that these amounts are subject to a substantial risk of forfeiture or they become immediately taxable, even if the participants are not currently receiving benefits.

Design Considerations

The American Jobs Creation Act of 2004 enacted new Section 409A of the Internal Revenue Code. This new code section significantly changed nonqualified deferred compensation rules. If a plan fails to meet the new rules, compensation deferred under the plan becomes immediately taxable, and penalties and interest apply. All plans had to comply with the final regulations under IRC Sec. 409A as of January 1, 2009. Therefore, it is crucial for your clients to work with trusted advisors. In addition to complying with these new regulations, your clients should consider the following design considerations:

- Eligibility of key employees, while considering that the plan must restrict benefits to upper management and highly compensated employees;
- The conditions that would forfeit future benefits;
- Incentives that the benefits are based upon; and
- Vesting of benefits

Funding of Arrangements

Plans can either be classified as a funded or unfunded arrangement. As the name implies, an unfunded plan

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has no specific reserve set aside to fund the plan. It is an unsecured promise, and the assets targeted to fund the plan are general assets of the business and subject to creditors. If the plan is funded with a specific reserve, deferral of taxation is more complicated because the plan must demonstrate a substantial risk of forfeiture. For this reason most plans are considered unfunded arrangements.

Meeting the Employer's Obligation

A deferred compensation plan will create a deferred liability to the business, and most will choose to set aside funds to meet these obligations. It is important to remember that the plan will, in most instances, be an unfunded plan and the assets set aside are a general asset of the business, subject to creditors. Also, the business should hold all rights to the fund and should not grant any vesting rights in any of the assets to the participants before benefits are paid.

Because of its unique characteristics, life insurance is the most commonly used asset to "informally fund" an unfunded deferred compensation plan. The cash values grow tax deferred, tax-free death benefits create an immediate fund to pay survivor benefits to heirs, and cash values can be accessed tax free to pay retirement benefits via withdrawals and policy loans if the policy is not a Modified Endowment Contract. It is important to note that if life insurance is used to informally fund the plan, the employer must comply with the notice and consent requirements of IRC Sec. 101(j). If not, the employer would lose many of the tax advantages life insurance can offer. Remember, the life insurance policy is not the plan; it's a general asset of the business.

Participant Taxation

The amounts in an unfunded arrangement are generally includible in the participant's gross income for the year they are actually or constructively received. A funded plan must make sure there is a risk of forfeiture or the plan becomes taxable immediately.

In addition to adhering to the new 409A rules, nonqualified deferred compensation plans must meet three conditions in order to avoid immediate taxation:

1. The income deferral was agreed upon before compensation was earned;
2. The deferred amounts were not unconditionally placed in escrow or trust; and
3. The employer's promise to pay was merely a contractual obligation and was unsecured.

The new IRC Sec. 409A may be a little intimidating to some employers, however with the help of trusted advisors, it should not present any hurdles to accomplishing the objectives of most small employers whose stock is not traded publicly. If the objective is to tie the key employee to the owner's business, nothing in the marketplace can accomplish this as effectively as nonqualified deferred compensation. The future payments are the "carrot," and the plan and the conditions of the plan are the "golden handcuffs" keeping the key employee as a valuable member of the operating team.

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AVIVA

Reducing Transfer Taxes Through Discounting

Do you have clients with substantial wealth who could benefit by transferring assets at a fraction of their fair market value?

Minority interests in certain types of entities (i.e. Family Limited Partnerships, Family Limited Liability Companies, etc.) can be transferred for less than the value of the assets owned by the entity. This is because the ownership of a minority (i.e. non-controlling) interest in a family business does not: (1) provide the ability to control the entity or its underlying assets; or (2) provide a market where the ownership interest can be freely transferred to non-family members. This lack of control and lack of marketability reduce the value of the business interest and therefore allows a reduction in transfer (gift and/or estate) taxes.

Lack of Control Discount

This discount is often applied to transfers during life or at death and reflects the inability of the minority owner to control the entity and the assets owned by the entity. Minority owners cannot dictate management decisions regarding the entity's direction; cannot dictate investment decisions regarding the entity's assets; and are at the mercy of those who "control" the entity. Lack of control discounts are applicable not only to "minority interests" (less than 51% ownership) but can be applied to "non-voting" and "limited" interests in the entity. Typical discounts for lack of control generally range between 20 percent and 30 percent.

Lack of Marketability Discount

This discount is often applied to transfers of minority interests because of the inability to negotiate the sale of the interest in a readily available market. Most family-owned businesses contain specific provisions ensuring that ownership of the interests will remain within the family group. Each of these provisions, by design, reduces the owner's ability to sell his/her interest and thereby reduces its value.

Several factors can influence the level of discount for lack of marketability. These factors include, but are not limited to, the entity's asset mix (i.e. marketable securities, real property, etc.) and transfer restrictions contained in the entity's legal documents. Typical discounts for lack of marketability also range up to 30 percent.

Bottom Line

Valuable assets such as a successful family business, real estate, etc., can be transferred to the next generation in a very tax-efficient manner. Parents can gradually give away business units which represent the bulk of the economic ownership of the entity while maintaining control of the business. Discounting for transfers of minority interests, limited interests and/or non-voting interests can be an effective way to transfer significant amounts for a fraction of the overall value. These discounts must be determined by a qualified appraiser in conjunction with an experienced estate planning attorney.

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Restricted Executive Bonus

A restricted executive bonus is identical to the Executive Bonus plan but restricts the executive's ability to access the policy's cash value for a period of time. The executive bonus plan is an effort to recruit, reward and/or retain top talent. The employer agrees to pay the premiums on a life insurance policy owned by the executive. This amount is includible in the executive's compensation and is generally deductible to the employer (it would not be deductible to the extent that his or her compensation is not "reasonable" IRC 162).

The policy is under the complete control of the executive with the exception of withdrawing cash value or receiving loans from the policy for a period of time (the restriction period). The employer has no interest in the policy. The executive can change the beneficiary, take a withdrawal from the policy (after the restriction period), take a loan against the policy (after the restriction period), collaterally assign the policy (after the restriction period), and may consider transferring the policy to an irrevocable trust (ILIT) for estate planning purposes. If the policy is transferred to an ILIT, the transfer will have gift tax implications, three year inclusion implications, and transfer for value implications. All implications can be adequately handled with proper planning (eg. the executive can make cash gifts to the ILIT using his/her annual exclusions, the ILIT is structured as a "grantor trust", and the ILIT trustee purchases the policy from the executive).

This arrangement is slightly more handcuff than the executive bonus in that the executive cannot access policy values for a set period of time without the employer's consent but he/she can still terminate employment and does not forfeit any rights or benefits in the policy. If a slightly stronger handcuff is desired see "Golden Executive Bonus Arrangement". If a complete handcuff is desired see "Employer Loans" or "Employer Endorsement".

Pros	Cons
Simple to understand and administer	Still is not much of a handcuff – Executive is free to leave and take policy
Valuable benefit for Executive	Is classified as a welfare benefit plan for ERISA purposes
Helps recruit, reward, retain – a slightly compensation stronger handcuff than executive bonus without restriction	Entire premium amount is included in Executive's – as opposed to premium sharing arrangements
Generally deductible to Employer	

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AVIVA

S-Corp Redemption Buy-Sell

- Buy/sell planning is a critical element of any successful business.
- It provides a definite market for transferring the ownership interest. The co-owners or business entity must purchase the interest.
- It specifies a set or determinable price. This price may also set the value used for estate tax calculation.
- It provides some or all of the funds necessary to execute the agreement – when properly funded with life insurance.
- It maintains "closeness" of the business by restricting and planning who/what can receive the business interests.
- It provides liquidity to pay estate taxes (due 9 months from date of death).
- It makes the entity a better credit risk because of the probability of business continuing past an owner's death.
- All businesses can benefit from buy-sell planning – sole proprietorship, C Corporation, S Corporation, Partnerships, LLCs, etc.

How S corporation stock redemption works: (for cash basis – NOT accrual basis - S Corporations):

- At an owner's death, disability or departure, the corporation agrees to purchase the business interest from the owner– this is documented in a formal agreement between the corporation and the owners.
- The corporation applies for (and is beneficiary of) a life insurance policy on each owner.
- At death, the corporation redeems the deceased shareholder's interest for a promissory note. This eliminates the deceased shareholder's estate as a shareholder of the S corporation.
- The corporation then elects a short tax year under IRC 1377 (a)(2).
- The corporation then receives the policy's death benefit after the start of the new tax year. Receipt of policy death benefit increases the basis in current shareholder's stock. "Current shareholder" includes the surviving shareholders and does not include the deceased shareholder or his/her estate.
- The corporation pays off the note with the policy death benefit.

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Results:

- Estate's non-liquid asset (i.e. the business interest) is sold to the corporation at an agreed upon price (little or no gain should be taxable due to step-up in basis at date of death)
- The business interest does not pass to any unintended parties.
- A minimal amount of administration is required since only one policy per owner needs to be purchased and maintained.
- Corporation provides premium payments thus avoiding any inequity/unfairness associated with individual premium payments with cross-purchase planning.
- The policy's cash value is an asset on the business' balance sheet offsetting the redemption obligation.
- The surviving shareholders receive a step-up in basis according to their ownership interest.

Why life insurance:

- Cash value inside a policy grows tax-free.
- Death proceeds are received income-tax free and received at just the right time to fulfill the agreement.

In order for the death proceeds to receive income-tax free treatment, the Pension Protection Act of 2006 requires two items:

- The consent and notice requirements are met; and
- The insured is a key person or the ultimate payee (not beneficiary) is:

  A member of the insured's family;

  The designated beneficiary (other than employer);

  A trust established for the benefit of any such person; or

  The insured's estate.

Disadvantages:

- Policy cash value is potentially subject to corporation's creditors.
- Premium payments are not deductible.

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Self Canceling Installment Note

A Self Canceling Installment Note (SCIN) is often used when transferring highly appreciating or income producing assets to subsequent generations.

The client sells the asset(s) to a trust or individual in exchange for an installment note payable over a specified period of time.

The seller will recognize gain over the term of years. The installment sale rules are very complex.

The assets sold will hopefully provide sufficient income to cover the debt service.

The note term must be less than the life expectancy of the seller and will contain a self-canceling clause in the event of seller's death.

The note must bear an adequate rate of interest based on the note's duration – based on the applicable federal rate (short-term, mid-term, or long-term). The SCIN interest rate must contain a risk premium to compensate in the event of an early death.

If the risk premium is not sufficient, then the transaction will be treated as a part-sale, part-gift transfer.

The self-canceling feature can be used as an effective means of transferring property to individuals or trusts without estate or gift tax consequences.

How it works:

1. Client sells asset to buyer. The note bears a rate equal to the applicable federal rate based on the term of the note plus a risk premium.
2. Buyer receives the asset(s) and agrees to make installment payments to seller.
3. Seller receives payments and reports gain spread over the term of the note.
4. If seller dies before the final payment, the note is canceled.
5. If buyer dies before the final payment, the buyer's estate must continue making payments until note is satisfied.

Here is where a life insurance policy can cover the risk of non-payment.

Bottom line:

SCINs can be an effective mechanism in transferring assets to subsequent generations at little to no gift and/or estate tax costs.

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17101

3/11

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Stock Redemption Buy-Sell

- Buy/sell planning is a critical element of any successful business.
- It provides a definite market for transferring the ownership interest. The co-owners, business entity or key employees must purchase the interest.
- It specifies a set or determinable price. This price may also set the value used for estate tax calculation.
- It provides some or all of the funds necessary to execute the agreement – when properly funded with life insurance.
- It maintains "closeness" of the business by restricting and planning who/what can receive the business interests.
- It provides liquidity to pay estate taxes (due 9 months from date of death).
- It makes the entity a better credit risk because of the probability of business continuing past an owner's death.
- All businesses can benefit from buy-sell planning – sole proprietorship, C Corporation, S Corporation, Partnerships, LLCs, etc.

How stock redemption works:

1. At an owner's death, disability or departure, the corporation agrees to purchase the business interest from the owner– this is documented in a formal agreement between the corporation and the owners.
2. The corporation applies for (and is beneficiary of) a life insurance policy on each owner.
3. At death, the corporation receives the policy death proceeds.

a. If departure is for reasons other than death (i.e. disability) the policy's cash values can be accessed to partially or totally fund the purchase.

4. The corporation purchases (redeems) the agreed business interest from the decedent's estate.

Results:

- Estate's nonliquid asset (i.e. the business interest) is sold to the corporation at an agreed upon price (little or no gain should be taxable due to step-up in basis at date of death.
- The business interest does not pass to any unintended parties.
- A minimal amount of administration is required since only one policy per owner needs to be purchased and maintained.
- Corporation provides premium payments thus avoiding any inequity/ unfairness associated with individual premium payments with cross-purchase planning.
- The policy's cash value is an asset on the business' balance sheet offsetting the redemption obligation.

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17119 3/11

Why life insurance:

- Cash value inside a policy grows tax-free (subject to potential AMT if C Corporation).
- Death proceeds are received income-tax free (subject to potential AMT if C Corporation) and received at just the right time to fulfill the agreement.
  - In order for the death proceeds to receive income-tax free treatment, the Pension Protection Act of 2006 requires two items are met:
    - The notice and consent requirements are met; and
    - The insured is a key person or the ultimate payee (not beneficiary) is:
      - A member of the insured's family;
      - The designated beneficiary (other than employer);
      - A trust established for the benefit of any such person; or
      - The insured's estate.

Disadvantages:

- Policy cash value is potentially subject to corporation's creditors.
- Premium payments are not deductible.
- Remaining business owners do not received a basis increase in their ownership interest.*
- Possible dividend treatment in family situations. In a family-owned corporation, the redemption may be treated as a dividend instead of a capital gain.

* S corporation remaining owners may be able to receive a stepped-up basis with proper redemption planning.

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"Stretch IRA"

One of the primary benefits of an Individual Retirement Account (IRA) is the ability to defer taxes. The longer the deferral, the faster, typically, the IRA will grow. Unfortunately, the Treasury Department eventually asks for its share of that growth, known as the Required Beginning Date.

The Required Beginning Date for IRA owners is no later than April 1 following the year the owner reaches age 70.5 (i.e.– If an IRA owner reaches age 70.5 in March 2009, the Required Beginning Date is no later than April 1, 2010). The Required Beginning Date for beneficiaries of IRAs is December 31 following the year of death; however in cases in which the IRA owner has not taken a Required Minimum Distribution (RMD) for the year of death, the beneficiary is also required to take this distribution by December 31 of that year. The failure to make these distributions will result in a 50 percent tax penalty.

When people refer to a "stretch" IRA, it means the RMD is taken each year by the account owner and their designated beneficiaries, thereby extending the period for maximum deferral. When someone is taking RMDs, it is most often a situation when the owner does not need the money and has other sources for current income.

To maximize the deferral period, the following guidelines should be followed. Each situation is different and should be planned based on variables such as age, marital status, age of spouse, number of children and grandchildren, and financial status. Generally the account should:

1. Name the spouse as primary beneficiary.
2. Name the children and/or grandchildren as contingent beneficiaries.
3. Ultimately divide the accounts into separate accounts before the IRA reaches the contingent beneficiaries.

Naming the spouse as primary beneficiary allows for the most flexibility when deferring taxes. Upon the death of the owner, the spouse has the option to:

1. Keep the account in the deceased person's name and defer RMDs until the deceased spouse would have been 70.5.
2. Complete a spousal rollover and assume the account as if it were his or her own. This would allow the spouse to defer RMDs until the spouse is age 70.5. The spousal rollover is available at any time.
3. Disclaim the property as if the spouse was never a beneficiary. This would make the contingent beneficiaries primary.

Once the spouse has decided the best course of action, the account needs to be divided into separate accounts. This allows each beneficiary to use his or her life expectancy for computing RMDs. If the accounts are not divided, the oldest beneficiary's life expectancy must be used. The account can be divided into separate accounts at any time, as long as it is before December 31 of the year following the year of death of the IRA owner. To guarantee that the separation will happen, many IRA owners will divide the IRA into separate accounts for each contingent beneficiary prior to death.

Continued ▸

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IRC Sec. 691(c) Deduction

The 691(c) deduction is another potential benefit of the stretch IRA. If estate taxes are payable on the IRA, there is a partial income tax deduction for the payment of those estate taxes. Special care needs to be taken when counseling inherited IRA owners because many times the estate tax return is prepared by advisors of the owner and not the advisors of the beneficiaries.

In summary, the many benefits and the potential risk of the stretch IRA need to be discussed in detail with the IRA owner.

Benefits and Risks

Benefits

1. **Income for Life:** A stretch IRA can provide lifetime income to the beneficiaries.
2. **Minimize tax liability:** By withdrawing smaller amounts over time, there is a potential to pay lower taxes due to lower brackets.
3. **Continued tax deferral:** Continued tax-deferred growth has the potential to increase the wealth passed to heirs.

Risks

1. **Estate Taxes:** If estate taxes are due and the estate needs IRA monies to pay these taxes, there might not be anything left to stretch.
2. **Tax laws may change:** Tax laws may change that significantly minimize the benefits of the stretch. e.g. - Tax rates in the future could be significantly higher.
3. **Poor returns on the IRA:** Investment losses could completely wipe out the potential value of future IRA distributions.
4. **Lump Sum distributions:** Beneficiaries have the right to withdraw more than the Required Minimum Distribution. If this is a concern the account owner should discuss with advisors establishing a trust should be discussed with their advisors. If done correctly, a trust can be used as a vehicle to guarantee that only the Required Minimum Distribution is withdrawn each year from the inherited IRA

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Traditional IRA, Roth IRA or…

What is the best accumulation vehicle to help supplement your client's retirement?

Depends …

Depends on what? Depends on how they feel about their future marginal tax bracket.

Lower – Traditional IRA, but do they qualify?

Higher – Roth IRA, but do they make too much money?

If they are convinced they will be in a lower bracket at retirement, a Traditional IRA is great. Defer tax in a higher bracket, pay tax in a lower bracket. No brainer right? Not so fast. What if they don't qualify because they are covered under a qualified plan or they make to much money? Also, being in a lower bracket at retirement might not be a given. Many times people lose deductions at retirement. No more dependents, no mortgage interest deductions, lower charitable contributions, no business expenses, in addition they may be assuming Congress won't raise taxes in the future. This could be wishful thinking.

O.K., so if they don't qualify for a Traditional IRA or if they think they might be in the same marginal bracket or higher, how about a Roth IRA? Roth IRAs are great; pay tax now and never pay tax again. But what if they don't qualify because they make to much money or they want to contribute more than is allowed? Are there alternatives?

YES! **Roth 401(k)** and **Life Insurance**

Roth 401(K)

Starting in 2006, participants in qualified plans were given the opportunity to elect after-tax contributions to a Roth 401(k) account, if the plan adopted this feature. The key is if the employer adopted the Roth provision in the qualified plan. Roth accounts inside qualified plans require separate accounting. This could increase administrative cost and therefore may not be desirable to the employer. If it is available, a Roth contribution to a qualified plan works just like a Roth IRA except: 1. there are no income qualifications 2. they are subject to required minimum distributions and 3. the amounts contributed are the same deferral limits as non-Roth 401 (k) contributions.

Life Insurance

A properly funded life insurance policy can be a great accumulation vehicle because it is taxed just like a Roth IRA, but has several advantages. A properly funded life insurance policy in this situation means a policy that is maximum funded and is not a Modified Endowment Contract. It is also critical that the contract stay in force until death in order to avoid taxation of any gain borrowed during life.

Advantages of Life Insurance:

- Creates an immediate estate. If the insured dies prematurely, the plan will be self-completing. The beneficiaries receive income tax free death benefit not just equal to contributions and interest, but the full face amount.
- No compensation requirements or fixed contribution limitations.
- Earnings can be accessed prior to age 59 ½ without penalty.
- Can produce significant IRR on the accumulated cash values in the future and on death benefit in the early years.

Continued ▸

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Side-by-side Comparison

Below is a comparison of key features of a Roth IRA and a life insurance policy. In this example, the life insurance policy is not a Modified Endowment Contract (MEC) and stays inforce until death of the insured.

Feature	Roth IRA	Life Insurance
Non-Deductible Contribution	Yes	Yes
Tax-Deferred Growth	Yes	Yes
Defer Distributions Until death	Yes	Yes
Income Tax Free to Beneficiaries	Yes	Yes
No Compensation Requirements	No	Yes
No Income Limitations	No	Yes
Unlimited Contribution Limitations	No	Yes (Subject to Insurability)
Early Withdrawals of Gain Without Penalty	No	Yes
Immediate Estate Creation Upon Premature Death	No	Yes

At the end of the day, what is best for your client depends on many factors. No matter what option is chosen, indexed annuities and life insurance are great choices to help accumulate money on a tax favorable basis for retirement. Aviva Life and Annuity are the market leaders for both.

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Wealth Maximization

Wealth Max is an estate planning technique for transferring the value in a deferred annuity into a more transfer tax efficient arrangement using an ILIT and life insurance policy.

The appropriate Wealth Max prospect is a client with a large deferred annuity that will not be needed to support his/her/their retirement.

Taxation:

- Annuities owned at death are subject to estate inclusion thus increasing any estate taxes owed.
- Annuities do not receive a "stepped up basis" at death
- Amounts received by the decedent's beneficiary are taxable as ordinary income (income in respect of a decedent) - the same as if the decedent had received the distribution

The Process

1. Client establishes an irrevocable life insurance trust (ILIT) that is owner and beneficiary of a life insurance policy insuring client(s)
2. Client takes distributions from annuity.
3. Distributions may be subject to surrender charges and may be subject to a 10% penalty unless an exception exists Exceptions include (IRC § 72(q):
   a. Client is age 59 ½ or older
   b. Client is disabled
   c. Distribution is part of a series of substantially equal periodic payments
4. Client pays income tax on annuity distribution received
5. Client gifts remaining distribution to ILIT
6. ILIT Trustee sends out Crummey notices to make the gifts a "present interest", allowing client to use annual exclusions
7. Trustee pays premiums on life insurance policy (Consider using a "No-Lapse Guarantee" product or rider to guarantee Death Benefit)
8. At client's/insured's death, Trustee collects life insurance policy proceeds that are free from income and estate taxes

Advantages

- Unneeded annuity's value is transferred to the next generation (or subsequent generations) in a tax-efficient manner
- Reduces (or eliminates if a life only annuity) estate and income taxes associated with owning an annuity at death and subsequent distributions from that annuity
- Can provide for an orderly distribution or retention of ILIT assets

Bottom line

Wealth Max can be an effective way for your client to minimize estate and income taxes associated with owning an unneeded annuity, and maximize the amount of wealth transferred to subsequent generations.

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2011 Tax & Section 415 information

2011 Income Tax

Standard deduction	
Single or Married filing separately:	$5,800
Married, filing jointly:	$11,600
Head of household:	$8,500

ATM Exemptions	
Individuals	$48,450
Married filing jointly	$74,450

Long-term capital gains and qualified dividends	
10% and 15% tax brackets:	0%
Above 15% tax bracket:	15%
Capital gains on collectibles:	28%

Retirement plans (415 Limits)

IRA/Roth IRA	
IRA contribution (under age 50)/Roth IRA	$5,000
IRA contribution (50 and older))/Roth IRA	$6,000
IRA deduction phase-out (qualified plan participant)	
- Single or HOH:	$56,000-$66,000
- Married, filing jointly:	$70,000-$110,000
- Married, filing separately:	$0-$10,000
- Spousal IRA deduction phase-out	$167,000-$176,000

Phase-out of Roth IRA contribution eligibility	
Single	$105,000-$120,000
Married, filing jointly:	$167,000-$177,000
Married, filing separately:	$0-$10,000
No Roth Conversion if MAGI exceeds $1,000,000 or married, filing separately. (No income limit beginning 2010)	

Employer Sponsored Retirement Plans (SEP)	
SEP contributions:	up to 25% of compensation (limit $49,000)
Minimum compensation for SEP participant	$550

SIMPLE Plan	
SIMPLE elective deferral (under age 50)	$11,500
SIMPLE elective deferral (50 and older)	$14,000

Individual 401(k)	
Employer contribution:	up to 25% of compensation
Employee salary deferral (under 50):	$16,500
Employee salary deferral (50 and older):	$22,000
Total employer & employee additions:	$49,000
	($54,500 age 50 and older)

Other retirement plans	
403(b), 457, and SARSEP elective deferral (under 50)[1]	$16,500
403(b), 457, and SARSEP elective deferral (50 & older):	$22,000
Section 415 limit on additions to defined contribution plans:	$49,000
Section 415 limit on defined benefit plans:	$195,000
Highly compensated employee:	$110,000
Annual limit on includible compensation	$245,000
Key Employee in Top-Heavy plan	$160,000

Gift and estate taxes	
Gift tax annual exclusion:	$13,000
Annual marital exclusion for gift to non-citizen spouse	$133,000
Highest gift tax rate:	35%
Estate tax exclusion amount:**	$5,000,000
Gift tax lifetime exemption:	$5,000,000
Generation skipping transfer tax exclusion:	$5,000,000

Social Security	
2011 Wage Base	$106,800
Social Security Subject to federal income tax:[2]	
Single or HOH	
50% taxable:	$25,000 MAGI*
85% taxable:	$34,000 MAGI
Married, filing jointly	
50% taxable:	$32,000 MAGI
85% taxable:	$44,000 MAGI
Maximum earnings (from a job) between age 62 and normal Social Security Retirement age before Social Security benefits are reduced $1 for every additional $2 earned:	$14,160

* Modified Adjusted Gross Income

** Portability provision for surviving spouse

[1] Additional catch-up contributions may be available for 403(b) participants with 15 or more years of service. In last 3 years pre-retirement, 457 participants may be able to increase elective deferral if needed to catch up on missed contributions.

[2] Most income, including municipal bond interest, but only 1/2 of Social Security benefits.

Federal income tax rates

Taxable income between

Unmarried Individuals		Married, Filing Jointly		Head of Households		Married, Filing Separately		Estates and Trusts	
$0 - $8,500	10%	$0 - $17,000	10%	$0 - $12,150	10%	$0 - $8,500	10%	$0 - $2,300	15%
$8,500 - $34,500	15%	$17,000 - $69,000	15%	$12,150 - $46,250	15%	$8,500 - $34,500	15%	$2,300 - $5,450	25%
$34,500 - $83,600	25%	$69,000 - $139,350	25%	$46,250 - $119,400	25%	$34,500 - $69,675	25%	$5,450 - $8,300	28%
$83,600 - $174,400	28%	$139,350 - $212,300	28%	$119,400 - $193,350	28%	$69,675 - $106,150	28%	$8,300 - $11,350	33%
$174,400 - $379,500	33%	$212,300 - $379,150	33%	$190,350 - $379,150	33%	$106,150 - $189,575	33%	Over $11,350	35%
Over $379,500	35%	Over $379,150	35%	Over $379,150	35%	Over $189,575	35%		

2011 Tax Summary

Uniform Lifetime Table

The table is used to determine the required minimum distributions from IRAs and Qualified Plans during the owner's life in situations in which the owner's spouse is either not the sole designated beneficiary or is the sole designated beneficiary but is not more than 10 years younger than the owner. (Joint Life Publication 590 if owner's spouse more then 10 years younger.)

Age	Divisor	% Account Balance	Age	Divisor	% Account Balance	Age	Divisor	% Account Balance
70	27.4	3.64	**82**	17.1	5.84	**94**	9.1	10.98
71	26.5	3.77	**83**	16.3	6.13	**95**	8.6	11.62
72	25.6	3.90	**84**	15.5	6.45	**96**	8.1	12.34
73	24.7	4.04	**85**	14.8	6.75	**97**	7.6	13.15
74	23.8	4.20	**86**	14.1	7.09	**98**	7.1	14.08
75	22.9	4.36	**87**	13.4	7.46	**99**	6.7	14.92
76	22.0	4.54	**88**	12.7	8.33	**100**	6.3	15.87
77	21.2	4.71	**89**	12.0	8.33	**101**	5.9	16.90
78	20.3	4.92	**90**	11.4	8.77	**102**	5.5	18.20
79	19.5	5.12	**91**	10.8	9.25	**103**	5.2	19.20
80	18.7	5.34	**92**	10.2	9.80	**104**	4.9	20.40
81	17.9	5.58	**93**	9.6	10.41	**105**	4.5	22.20

Single Life Expectancy Table

This table may be used to determine the minimum amount of withdrawal that is required each year for an individual who inherits money as a designated beneficiary of an IRA. The individual must be specifically names as the beneficiary in order to use the table. If the estate is named or if no individual(s) is named as the beneficiary of the IRA the heirs will not be able to stretch out the withdrawals through use of the single life table.

Age	Divisor	Age	Divisor	Age	Divisor	Age	Divisor	Age	Divisor	Age	Divisor
Under 1	82.4	**19**	64.0	**38**	45.6	**57**	27.9	**76**	12.7	**95**	4.1
1	81.6	**20**	63.0	**39**	44.6	**58**	27.0	**77**	12.1	**96**	3.8
2	80.6	**21**	62.1	**40**	43.6	**59**	26.1	**78**	11.4	**97**	3.6
3	79.9	**22**	61.1	**41**	42.7	**60**	25.2	**79**	10.8	**98**	3.4
4	78.7	**23**	60.1	**42**	41.7	**61**	24.4	**80**	10.2	**99**	3.1
5	77.7	**24**	59.1	**43**	40.7	**62**	23.5	**81**	9.7	**100**	2.9
6	76.7	**25**	58.2	**44**	39.8	**63**	22.7	**82**	9.1	**101**	2.7
7	75.8	**26**	57.2	**45**	38.8	**64**	21.8	**83**	8.6	**102**	2.5
8	74.8	**27**	56.2	**46**	37.9	**65**	21.0	**84**	8.1	**103**	2.3
9	73.8	**28**	55.3	**47**	37.0	**66**	20.2	**85**	7.6	**104**	2.1
10	72.8	**29**	54.3	**48**	36.0	**67**	19.4	**86**	7.1	**105**	1.9
11	71.8	**30**	53.3	**49**	35.1	**68**	18.6	**87**	6.7	**106**	1.7
12	70.8	**31**	52.4	**50**	34.2	**69**	17.8	**88**	6.3	**107**	1.5
13	69.9	**32**	51.4	**51**	33.3	**70**	17.0	**89**	5.9	**108**	1.4
14	68.9	**33**	50.1	**52**	32.3	**71**	16.3	**90**	5.5	**109**	1.2
15	67.9	**34**	49.1	**53**	31.4	**72**	15.5	**91**	5.2	**110**	1.1
16	66.9	**35**	48.5	**54**	30.5	**73**	14.8	**92**	4.9	**111+**	1.0
17	66.0	**36**	47.5	**55**	29.6	**74**	14.1	**93**	4.6		
18	65.0	**37**	46.5	**56**	28.7	**75**	13.4	**94**	4.3		

Information is accurate at time of printing, February, 2011.

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