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LAW LETTER

Annuity Contracts

A New Strategy in Estate Planning?

Texas insurance companies may play a greater role in estate planning. In the past, life insurance provided a source of funds to retire debts against a deceased's estate including state inheritance taxes and federal gift and estate taxes. Under a new law passed by the 73rd Texas Legislature, effective September 1, 1993, annuity contracts issued by insurance companies may assume a more significant role.

The new law, amending Section 21.22 of the Texas Insurance Code, clothes annuity contracts with the same protection as homesteads and personal exempt property. The fact that the new law has received little or no attention is based partly on its location in the statutes.

Generally, property exempt from execution by creditors is mentioned in either chapters 41 or 42 of the Texas Property Code. Chapter 41 describes the Texas Homestead Law–the real property not subject to execution by creditors. Chapter 42 lists the personal property exempt from execution. With few exceptions, the exempt personal property consists of 12 designated types of personalty not exceeding $60,000 in the aggregate for a family or $30,000 for a single adult.

The twelfth type of property on the list is the present value of any life insurance policy to the extent that a member of the insured's family or a dependent of a single adult claiming the exemption is a beneficiary of the policy. Nothing else refers to annuity contracts issued by insurance companies. The newly revised Section 21.22 of the Insurance Code supplements the list.

The new law provides that " . . . all money or benefits . . . to be paid or rendered to the insured or any beneficiary under any policy of insurance or *annuity contract* issued by a life, health or accident insurance company . . . shall:

- inure exclusively to the benefit for whose use and benefit the insurance or annuity is designated in the policy or contract;
- be fully exempt from execution, attachment, garnishment or other process;
- be fully exempt from being seized, taken or appropriated or applied by any legal or equitable process or operation of law to pay any debt or liability of the insured or of any beneficiary, either before or after said money or benefits is or are paid or rendered;
- be fully exempt from all demands in any bankruptcy proceeding of the insured or beneficiary."

Other provisions of the amendment provide that an annuity contract issued by a life, health or accident insurance company shall be considered a *policy or contract of insurance*. If any policy of insurance or annuity contract prohibits the beneficiary from assigning the contract or any of its benefits, the provisions shall be strictly enforced.

What exactly is an annuity or an annuity contract? How can annuity contracts be used in estate planning?

An annuity is a monthly or annual payment receivable for life or a specified number of years. An annuity contract is a contract issued by an insurance company agreeing to make the annuity payments. The payments may start immediately or begin at some future date. They may last for a term of years or for the remainder of the insured's life. Generally, the amount of the payment is fixed.

The amount of the monthly or annual payment depends on several factors. These include (1) the magnitude of the premium or premiums paid for the contract, (2) the anticipated lifetime of the insured (if for life) or otherwise the length of the payment period and (3) the returns the insurance company can earn from the premium or premiums.

One way to use an annuity contract in estate planning is demonstrated in this scenario. Suppose an individual has an estate exceeding $600,000 subject to federal gift and estate taxes at death.

Obviously, the person may purchase and properly structure a life insurance policy to cover the taxes without having the value of the policy included in the estate. (See "That's Rich," *Tierra Grande*, Summer 1993, for more details.) Also, the person may gradually lower the estate by gifting no more than $10,000 per year to any one person.

Effective September 1, 1993, the law creates a new way to lower the value of the estate without giving it away. By purchasing an annuity contract payable for life, the estate planner can lower the value of the estate by the amount of the premium or premiums. At the same time, the estate planner will receive a guaranteed income for life free from creditors.

For instance, based on current rates, a 65-year-old male could purchase a $100,000 annuity contract, payable immediately, that would return $730 per month. A 65-year old female could purchase the same contract and receive $654 per month because her life expectancy is longer.

There is no limit on how much money can be protected with an annuity contract. The aggregate amount of personalty that can be protected under Chapter 42 of the Texas Property Code is $60,000. Because the annuity exemption appears in the Insurance Code, not the Property Code, the $60,000 cap does not apply.

Part of the income stream from the annuity is subject to income taxes, however. To the extent that each annuity payment represents income and not a return of capital, it is taxable.

Of course, the annuity contract can be structured in an infinite number of ways. The preceding example is just one. If an annuity contract is structured so that a part of its value will be included in the deceased's estate, the remaining value can be left to a church, charity or other nonprofit organizations so its value becomes a charitable deduction.

The possibilities go beyond estate planning. Annuity contracts can be used by those who want a guaranteed lifetime income that cannot be reached by creditors. Also, in the event of a future bankruptcy or personal judgment, an annuity contract may afford financial protection of the estate.

One caveat must be added. The protection from creditors does not apply (1) to premium payments made in fraud of creditors subject to the applicable statute of limitations for their recovery or (2) to a debt of the insured or beneficiary secured by a pledge of the policy or its proceeds (Texas Insurance Code, Article 21.22, Section 3).

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