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"SPIAs and Universal Life: The Perfect Combo for Charitable Clients"

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Annuity Arbitrage Strategy Can Provide Benefits To Clients And Charities

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Ordinarily, individuals who make charitable gifts at death, referred to as "testamentary gifts" receive a Federal Estate Tax deduction for the amount that passes to charity, but they do not receive any income tax benefit. Oftentimes, people who opt for this form of charitable giving do so because they are not yet prepared to part with all personal benefit from the assets they plan to donate. By using an Annuity Arbitrage strategy, however, older clients (generally, age 65-85) who intend to make specified testamentary gifts can effectively have their cake and eat it too – through the receipt of an income tax benefit during their lifetimes while their favorite charities benefit at death. Moreover, the Annuity Arbitrage strategy can produce a very attractive net return on the funds committed to the plan, a return that can outperform fixed income alternatives and exceed the results that one might obtain through a charitable gift annuity.

An Annuity Arbitrage involves the purchase of two separate insurance products on the life of the same insured. One of the products purchased is a single premium immediate annuity (SPIA)[1] – which is an annuity where the insured makes a single large premium payment to the insurance carrier in exchange for the right to receive back level (usually annual) payments for the remainder of his or her lifetime. Upon death, the annuity terminates and the insurance carrier is not required to make any further payments. The amount of the annuity payment is generally much higher than the payment one would ordinarily receive on a fixed income investment in order to compensate the insured for the fact that the annuity terminates at his or her death – with no further benefit to the insured's family. Purchasing a SPIA on its own carries a considerable amount of risk because an early demise could result in the insured having received far less in annuity payments than was paid for the initial contract.

To offset this risk of loss, the Annuity Arbitrage Strategy also involves the purchase of a guaranteed universal life insurance policy, designed to require level annual premiums until the death of the insured. Paired together, the SPIA and the insurance policy act as a perfect complement to each other – with the SPIA providing high annual payments during the insured's lifetime and the insurance policy covering the loss of principal at the insured's death. By taking advantage of differing underwriting assumptions between the carrier that offers the annuity and the carrier that offers the life insurance policy, it is often possible to find a spread between the annual annuity payment and the annual life insurance premium that exceeds corporate and government bond rates. In a standard Annuity Arbitrage, the insured might own both the SPIA and the life insurance policy (or the life insurance policy might be held in an irrevocable trust for the benefit of the insured's children). In the charitable version of this strategy, the annuity is owned by the donor and the life insurance policy is owned by the charitable organization.

To begin the transaction, the charitable organization applies for a life insurance policy with a death benefit that is equal to the amount that the insured desires to transfer to the charity at death. At the same time, the donor applies for a SPIA that requires a single premium equal to the difference between the death benefit on the life insurance policy and the life insurance policy's annual premium.

When both policies are approved and issued, the donor funds the SPIA with the scheduled single premium and makes a tax-deductible contribution to the charity in the amount of the annual life insurance premium. Each year, the donor will use a portion of his or her annual annuity payment to make another donation to the charity in the amount of the life insurance premium, and will keep the difference. The annual SPIA payment is tax favored because the IRS considers a large portion of the payment to be "return of principal". Not until the principal has been deemed fully returned does the entire SPIA payment become taxable.

The return to the donor is the amount by which the annuity payment exceeds the life insurance premium after income taxes on the SPIA payment and the income tax deduction associated with the charitable contribution of the life insurance premium have been taken into account.

Overall, a Charitable Annuity Arbitrage can provide a donor with a very attractive annual net return on the funds committed to the strategy, while providing his or her favored charity with the desired benefit at death.

[1] Single Premium Immediate Annuities generally make fixed payments over the life of the insured. Payments, which consist of principal and interest, are typically not adjusted for inflation so the buying power of the payments issued may erode over time. Please note the decision to annuitize is irrevocable, and principal cannot be withdrawn at a rate greater than the contracted payout rate. All guarantees are subject to the claims paying ability of the issuing insurance company.