Is There an Annuity-Life Insurance Arb Opportunity?

By Kerry Pechter *Fri, Aug 10, 2012*

Can you use unneeded annuity assets or annuitized income to buy life insurance and create a tax-free bequest? Sure. Does it make sense for the client? Only under certain circumstances.

Taxes on the affluent are almost certain to rise, so many advisors are looking for ways to trim their clients' tax exposure. By funding a life insurance policy with the income from a life annuity, they can sometimes turn a highly taxed asset into a tax-free bequest.

Not long ago, for instance, a woman came to Teckmeyer Financial, in Omaha, Nebraska, with a deferred variable annuity. According to Joseph Hearn, one of Teckmeyer's advisors, her contract had an account value of $85,000, a lifetime income rider with a benefit base of $128,000, and a death benefit worth $104,000. Her purchase premium had been $70,000.

Were she to liquidate the annuity, she would get the $85,000 account value and pay ordinary income taxes on the $15,000 gains. Were she to die with the contract in force, her son would owe ordinary income tax on the difference between the original cost basis and the death benefit. For someone in the 28% tax bracket, the tax would be about $9,500.

The client had two goals: to get a little more money to live on, and to pass on the remainder to her son as tax efficiently as possible.

If she annuitized the contract, she could collect an income stream for life based on the larger $128,000 income base. That would bring in $764 a month or $9,168 per year, but it would also negate the death benefit.

With help from her advisor she found a permanent, universal life insurance policy with a $100,000 death benefit for only $366 a month. Over time, this would replace the annuity death benefit and come with the added advantage of being tax-free to her son. Meanwhile she could keep the remaining $398 to cover taxes on the annuity distributions and add to her income.

"It was a win-win-win," Hearn told RIJ. "It's not going to work for everybody, but she had an annuity already with a high income benefit, a high death benefit and a low contract value."

The same goal can be accomplished using an annuity/life insurance arbitrage, says Glenn Daily, a fee-only advisor in New York City. The advisor should shop for the highest-paying life annuity from one insurer and then hunt for life insurance with low premiums from another insurer.

"People who are in poor health can buy a substandard annuity that usually has bigger payouts," said Daily. (With a "substandard," impaired," or "medically-underwritten annuity," as they are variously called, someone with compromised health can receive the payout rate of someone with a higher age.)

Daily admits that most of the time when he runs the numbers, this arbitrage doesn't work and advisors have to really dig into the details of the life insurance policy. It is most likely to work if there's a favorable disparity in underwriting between the life annuity and the life insurance policy. If the client buys a no-lapse life policy, he'll have guaranteed benefits on both the annuity and life insurance. But "good insurance policies with low premiums are harder to find these days because of greater reserve requirements," Daily noted.

One trap to be wary of when buying a non-guaranteed universal life policy: If an insurance agent says he can credit the life insurance account at 5%. "That means they're still getting the benefit of older bonds in their portfolio," said Daily. "In this interest rate environment, that's bound to change, so if the advisor is running the numbers, he or she should be using a value closer to 3%." He warns that insurance agents will often simplify the tradeoffs to make the sale.

To make sure the evaluation is done right, advisors should look to see that three different amounts of after-tax annuity payments are going into the life insurance policy in sequence, said Daily. These would reflect the payments that are partly taxed under the exclusion ratio, the payments that are fully taxed after the cost basis has been recovered, and payments that are made during the period of up to one-year between the two.

"You should see three numbers on the analysis if it's done properly," he said. If the advisor doesn't do this level of analysis, his proposal may be "just a sales pitch thrown together to get the client to buy something." If the money is coming from a qualified plan, of course, this analysis is irrelevant.

Bob Keebler, a partner at Keebler & Co. in Green Bay, Wisconsin also uses this annuity/insurance combination as an added component of an estate tax reduction strategy for high net worth clients. fter he's finished moving qualified assets out of a client's taxable estate He moves IRA assets, for instance, to an irrevocable living trust (ILIT), thus reducing the estate, then buys life insurance with the assets to create the tax-free legacy.

"I had a lady who had $6 million in an IRA and $10 million in other property," he explained. "She annuitized $4 million from the IRA and used the income stream to buy a whole life insurance contract in an ILIT." While she would still have to pay estate taxes on assets above $5 million, "this was a step in the right direction," Keebler said.

Few clients have enough wealth to need an ILIT for tax purposes, given today's $5 million estate tax exemption ($10 million for couples), but no one knows how the exemption will change next year when the Bush tax cuts expire, he pointed out.

San Diego-based CPA Leonard Wright recommends ILITs even for the merely affluent, because it's a way to protect assets that they want to bequeath from potential lawsuits. "I'm a strong proponent of ILITs because unexpected things happen like divorces and car crashes," he said. "If the money is in an ILIT, it's protected by the trust and attorneys can't get their hands on it."

The annuity/life insurance arbitrage, as it were, does have drawbacks. The client loses flexibility on both the annuity sides and the life insurance side, says Keebler. "Once you give up control over your money and turn it into a stream of income payments, you've locked yourself in and may get nothing back from the life insurance policy if you change your mind. If you let the payments lapse you may have nothing but an annuity."

Furthermore, Wright said that now is a particularly bad time to buy a life annuity. "I would never recommend it since interest rates are at historic lows," he said. Instead he believes that a well-diversified portfolio will provide better rates of return to fund permanent life insurance. He is skeptical about using the arbitrage strategy. "Using an annuity to fund an ILIT is such a sales-y thing to me," he says. "I'm not really big on this because I see two commissions there. The client is going to pay 3% or 4% on that."

Nonetheless he would consider funding life insurance if the client already has an annuity or craves the security of a steady income stream. "There's the emotional aspect where consumers are shell-shocked because of the capital markets and are gravitating toward some kind of certainty," Wright said.

"That appeals to the emotional instinct in all of us—having the certainty of a fixed income annuity and a life insurance policy where the payments can't rise," he added. "I personally don't like it except where it's in the best interest of a client who wants that peace of mind, and where it makes sense in the context of their financial plan."