Free Money: How insurance + annuity = big profit

By Dan W. Holbrook

In recent years, insurance advisors have figured out a marvelous way for certain clients to get money out of the insurance industry, completely above board and legal. As attorneys, we may be asked whether it really works. The answer so far is yes, and it's been done many times successfully. In fact, it seems to require a rephrasing of tax attorneys' usual refrain: "If it's too good to be true, it ain't … unless, of course, it is."

Consider a client between ages 75 and 90, with above average health and wealth, who will never need any more life insurance. That client might well have a valuable unutilized asset, namely, his insurability. Here's how to convert that asset into cold cash.

STEP 1: Your client agrees to submit to an insurance medical examination. Because his health is generally good for his age, he is likely to qualify for standard rates. Because his wealth is significant, he can qualify for a lot of life insurance. [Insurance companies limit the amount of insurance they will underwrite on any one person, typically around $1\frac{1}{2}$ times net worth.]

STEP 2: Your client's insurance agent shops around for the best deal on life insurance. The life insurance contract will generally be guaranteed, that is, a fixed annual premium for the insured's entire life, with a guaranteed death benefit no matter how long he lives. The insurance company should be top-rated.

STEP 3: The agent then takes the same medical exam information and shops around for the best deal on a life annuity contract. A single premium insured annuity (often referred to as a SPIA) is a contract issued by an insurance company, in exchange for one lump sum, to pay a guaranteed annual annuity for the life of a person, no matter how long that person lives. Again, the company should be top-rated. This is where the fun begins.

Companies issuing annuities look at the underwriting data differently than do companies issuing life insurance policies. Almost anyone over age 75 has had some medical history that may shorten his life expectancy, justifying a larger annuity payment. This is typically referred to as an "age-rated SPIA." In other words, while a life insurance company competes in a market that values living beyond life expectancy, the annuity company competes in a market that values dying sooner. Both companies review the same data, but they calculate their expected profits on different products in different markets. The difference creates a financial spread and therefore an opportunity. [Current rule-of-thumb is that for every three clients who submit to this medical underwriting, only one will obtain a "spread" on the numbers sufficient to create enough profit to justify closing on this transaction. For the other two, the numbers just don't work well enough.]

Example 1: Based on her medical information, Doris, age 75, can qualify for $10 million of life insurance, for an annual premium of $600,000 per year, first payment due immediately. She can also qualify for an annuity contract that pays $1,200,000 per year for a lump sum payment of $8 million, first payment to begin a year from now.

STEP 4: Your client goes to a bank and borrows to finance the deal. Your client may be wealthy, but he is not interested in contributing cash to make this happen. A bank loan, secured by the life insurance policy and the annuity contract, closes the deal without any money invested by your client.

Example 2: Doris finds that her local bank is happy to loan her $9 million, at 4 percent annual interest

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payable during her life, with principal due only at her death. She closes on the bank loan, the insurance policy, and the annuity contract all on the same day. She uses $600,000 of the loan to pay the first year's insurance premium and $8 million to buy a SPIA that will pay $1,200,000 per year starting a year later. She can pocket the remaining $400,000 immediately, free of income tax. This also covers any "transaction costs" in setting up the whole deal.

STEP 5: As the years go by, the annual annuity payment will be sufficient to pay both the annual insurance premium and the interest on the note. During the years of the client's life expectancy, some of the annual annuity payment will be taxable income, but most will be tax-free return of principal. After the end of the life expectancy, all of the annuity income every year will be ordinary income. This is the one place where the client is exposed to potential liability. Usually at least some of the prior positive cash flow should be invested as a reserve to cover this contingency. A modest return on the re-invested cash flow should more than cover any late-year potential negative cash flow through the maximum insurance age of 110.

Example 3: At the end of each year, Doris receives an annuity payment of $1,200,000. She writes a check to the life insurance company for $600,000 to pay the annual premium and a check to the bank for $360,000 to pay the 4 percent annual interest on the $9 million loan. That leaves her with pre-tax cash flow of $240,000.

Doris's life expectancy is 12 years, so 1/12 of $8 million, or $667,000 per year, is tax-free to her as a return of basis, and the rest of the annuity, $533,000, is taxable income. After paying incremental income taxes of about $178,000, she will have an after-tax net annual cash flow of about $62,000 for the first 12 years. The total positive cash flow for the first 12 years, including the first $400,000 at the closing, and disregarding any earnings from re-investing, will be about $1,144,000.

Beginning in the 13th year, or starting at Doris's age 88, the annuity payment of $1,200,000 will be entirely ordinary income, on which the income taxes may be about $400,000. So beginning at age 88, Doris's annual after-tax cash flow may be negative $160,000. Whether or not this would be a problem for Doris depends on whether or not she has invested her prior positive cash flow as a reserve for this purpose or else has other liquid assets.

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STEP 6: Upon the client's death, the life insurance death benefit will pay off the loan and any accrued interest. The death benefit will exceed the payoff, creating a windfall for the client's testamentary beneficiaries.

Example 4: Doris dies in mid-year. The life insurance company pays her estate $10 million. Her executor pays off the bank debt of $9 million, along with $180,000 of accrued interest. The difference of $820,000 passes to the beneficiaries under her will.

Summary of net benefits to Doris or her estate:

$400,000 upon closing the deal.

After-tax positive cash flow of about $62,000 per year for 12 years, totaling $744,000.

After-tax negative cash flow of about $160,000 per year thereafter.

$820,000 upon her death.

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Arbitrage

This technique is known as "arbitrage," a term often carrying a negative connotation. Arbitrage is merely profiting from a spread, which for example is exactly how banks make all their money. The insurance industry is all about allocation and assumption of risk. So long as the insurance arbitrage is legal and fully disclosed to all participating parties, the fact that two different insurance companies are willing to enter into two separate contracts that create profit for the client is their risk, not the client's.

Note that the arbitrage comes in three phases: first, a possible immediate profit upon closing; second, a possible positive after-tax cash flow during the client's life; and third, a death benefit. Any specific transaction may be designed to include all three, or only one or two in any combination. This depends on the client's goals and can be determined after the underwriting by selecting the relative amounts of insurance, SPIA, and

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bank loan. The initial loan proceeds can also be used to make a larger initial payment to the insurance policy to reduce the subsequent premiums and therefore invest less in a SPIA. Or the lifetime cash flow can be used to purchase additional life insurance death benefit. Obviously, a range of models should be prepared, and the client should be advised on how to structure the deal to best meet his objectives.

Do these huge "spreads" in underwriting really exist? Yes, and billions of dollars of insurance are already in force based on this arbitrage.

Does the client assume risks? Some. The worst risk would be if either insurance company became insolvent and defaulted in its obligation. This is highly unlikely given the relatively short duration of the program, that is, the client's remaining life, especially if excellent insurance companies are selected at the start. Moreover, the client's risk of a default on the life insurance death benefit can be minimized if the bank will accept the life insurance policy and annuity contract as their only collateral, without any personal guarantee by the client. For example, an irrevocable trust could be the non-recourse borrower as well as the owner of both the life insurance policy and the annuity contract, so that the client's risk is essentially zero.

Can the client avoid estate tax on the death benefit arbitrage? Yes. If the beneficiary is charity, there is no estate tax owed because of the charitable deduction. If the beneficiary is a family member, then the life insurance may be excluded from estate taxation by using a life insurance trust. Can the client deduct the interest on the note? Normally, no. However, there are some creative possibilities to consider, such as structuring the note as a mortgage on the client's primary or secondary home.

Does the insurance agent make money? Yes, significant commissions on both the insurance and the annuity. No wonder insurance agents and brokerage houses have become quite sophisticated in packaging this program over the last several years.[1]

Bottom line: insurance/annuity arbitrage is a viable technique for certain older clients to convert their excess insurability into additional wealth for themselves, their families, or charity, but only if the underwriting numbers work in each particular case, the clients are fully informed, and the risks are managed.

Notes

1. Some recent innovations involve committing all of the death benefit arbitrage to charity. Under almost all state laws, including *Tenn. Code Ann.* Section 56-7-314, charities have an insurable interest in their donors and can therefore own the insurance and annuity. However, if a charity finances the deal by borrowing from a bank, it can create "unrelated business taxable income" (UBTI) to the charity under Internal Revenue Code Section 511. Recent approaches attempt to eliminate the charity's tax exposure, and perhaps also to reduce the other risks to the client and to charity, by including trusts, partnerships, or other legal entities, usually in consideration for some or all of the lifetime cash flow. There has been some national debate over whether such innovations are desirable as a matter of public policy. However, in 2004 the Tennessee legislature amended *Tenn. Code Ann.* Section 56-7-314 virtually unanimously to enable such arrangements to include both charitable and non-charitable entities, following similar statutory changes in Texas, North Carolina, Nebraska and Virginia, with other states likely to follow. The Tennessee statute seems a bit overbroad compared to those other states, but if the marketed programs generate no more than a reasonable return to third-party lenders or third-party investors while delivering a fair and reasonable share to charity, there is ample reason to believe both state and federal laws will continue to encourage their popularity.

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sleep and awakened into my daughter's *Beauty and the Beast* book.

To enter the Grand Ball, it was necessary to present the guards at the gate (with machine guns slung over their shoulders at a time before we in this country were accustomed to such sights) with an invitation and identification. To my surprise, we were passed through the gates and herded towards large white tents set up on the lawn. Having been to a couple of pretty fancy parties in East Tennessee, I assumed that they were having the party in these big tents. Instead, this was the coat check location. Having shed our coats, we were directed into the *Palais* where we joined a line of folks headed down a long flight of stairs. As we waited in line, we learned from our neighbors in line that the area in which the ball was to be held was the same area where Marie Antoinette was held prior to her execution. This was a place with some pretty serious history to go with it! At the bottom of the steps, the guests would tender to a gentleman in tuxedo and chain sash their invitation and be announced to the crowd. Now, I have to admit that, for a boy born next to a coal mine in West Virginia and raised next to a cattle barn in North Carolina, this was pretty heady stuff. You might forgive me if, for just a moment, I began to think that I had arrived and that I really *was* somebody. As my head swelled and my bride smiled, we handed our invitation to the gentleman, who turned and shouted to the assemblage "Monsieur and Madame Pam Reeves!" Yes, I was somebody all right. I was the guy who was "Drivin' Ms. Pammy."