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**Income and Estate Planning**

How strategy planners, charities and donors can use actuarial arbitrage to potentially eliminate risk.

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In my [last column](#), I revealed how Americans are the wealthiest and most charitably inclined people in the world. During the last quarter of the 20th century, there was unprecedented growth in the wealth held and controlled by individuals and families in the United States. By the beginning of this century, nearly five percent of all American households had a total household net worth of \$1 million or more. At a higher asset level, there were approximately three quarters of a million households in the United States with net assets in excess of \$5 million. Of these pentamillionaires, 40 percent fall in the 65-years-and-older age range.

The first step in addressing philanthropy in the process of comprehensive wealth planning is to understand the various tools of charitable giving within the parameters of the traditional planning processes. At a basic level, the objectives of traditional financial and estate planning can be distilled to the following fundamental strategies: produce income, protect income-producing assets and reduce or eliminate taxation both on the production of income and the transfer of those assets to or for the benefit of intended beneficiaries.

Advisors who engage individuals in planning will necessarily need to identify planning goals from among the objectives listed above. All of the above could essentially be reduced to two major issues:

1. I do not want to outlive my assets.
2. I want to pass on as much as possible of what is left.

Perhaps one of the least utilized planning techniques in estate and charitable planning that virtually perfectly addresses the two above mentioned goals is a strategy of actuarial arbitrage. In order to integrate planning tools and strategies effectively into the process of wealth planning and management, it is necessary to understand which insurance tools and techniques are capable to accomplish each of the stated general planning objectives.

**Traditional Actuarial Arbitrage**

The traditional actuarial arbitrage is a financial planning tool that creates much greater after-tax cash-flow and greater transfer to heirs than is otherwise possible with investment assets inside an estate. The traditional straddle, when used, increases after-tax cash-flow through life expectancy and estate transfers by 100 percent. It is a combination of two basic financial instruments: life insurance policy (LI) and a single premium immediate annuity (SPIA). The strategy attempts to use the different pricing of annuities and insurance products, on the same individual, in an arbitrage fashion. For example, as evidenced by the Internal Revenue Service's (IRS') shift in mortality tables, actuaries can use different assumptions in determining one's expected mortality. In an efficient market, the mortality assumptions built into annuity and insurance products should be the same; that is, each product should use the same actuarial assumptions for a given consumer regardless of which product — an annuity or insurance policy — the consumer is purchasing.

A shift in mortality to a longer expectancy means that a life insurance product, whose costs is based in part on how long the insured will live, will have lower premiums. Conversely, a shift in mortality to a lower life expectancy means that an annuity, whose payout is based in part on how long the insured will live, will have higher payouts.

The traditional actuarial straddle is able to increase after-tax cash-flow for an individual and eliminate certain assets from the individual's estate, which then results in reduced estate taxes. The asset used to purchase the SPIA is replaced with life insurance outside the estate. The straddle works ideally with older individuals who are over age 70 and are insurable as a table rating of "B" or better. Obviously, there is a play between the insurance company providing the life insurance and the one providing the SPIA because the actuarial assumptions are different. Life insurance is medically underwritten while annuities are generally not. Additionally, life insurance premiums are generally discounted by lapse ratios (since not all insurance policies are held to maturity). Typically, the straddle

uses a “life-only” annuity payout option whereby at death, the income stream ceases and the asset used to purchase the SPIA is eliminated and therefore not subject to estate taxes. But, at the same time, the life insurance owned outside the estate pays an offsetting or greater death benefit.

*In the non-charitable environment the Straddle is applicable to both qualified and nonqualified assets, by-pass trust funding, private premium financing and 1035 exchanges.*

There are also several unique applications of the concept within the context of Charitable Planning.

### **Charitable Remainder Trusts**

A charitable remainder trust makes payments to an individual (or individuals) beneficiary for a term of years or for the lifetime of the beneficiary. At the end of the trust term, the assets of the trust are distributed to a charitable organization. The payments to the beneficiary can be either in the form of an annuity or a unitrust amount. A charitable remainder annuity trust (CRAT) pays a fixed dollar amount each year to the beneficiary. A charitable remainder unitrust (CRUT) pays out a fixed percentage of the value of the trust's assets determined annually to the beneficiary.

CRATs buy both SPIA and life insurance policy on the life of the donor. The resulting net cash-flow is generally between eight percent and 12 percent before tax. At death the remainder (death benefit) is paid to the charity.

### **Charitable Lead Trusts (CLT)**

A qualified CLT grants a qualified income interest to one or more charities and provides for the remainder of the trust assets to pass to one or more non-charitable beneficiaries. A qualified income interest is either an annuity or a unitrust interest, payable at least annually.

The idea is the same as in CRATs. The life insurance and SPIA combination produces guaranteed stream of payments for the charity during the lifetime of the donor and GUARANTEES a 100-percent transfer of assets to non-charitable beneficiaries in the form of a death benefit.

### **The Common Gift Annuity**

This is funded either with cash or publicly traded securities. It is established either by a single donor who is also the annuitant or by a husband and wife who contribute jointly-owned or community property for a joint and survivor annuity. Annuity payments are made until the death of the sole or surviving annuitant, whereupon the residuum is used for charitable purposes. The problem generally is with the remainder. Gift annuities are priced in such a way as to retain one half of its original value at life expectancy. Essentially, someone making a \$1 million gift to his/her favorite charity in the form of a Gift Annuity is only making a gift of \$500,000.

If this person utilizes the actuarial arbitrage technique, there is a substantial guarantee that the charity will receive the full \$1 million without any reduction of income to the annuitant!

### **Conclusion**

When determining the overall investment policy to implement a CRAT, CLT or a gift annuity, several assumptions must be made. The first is an assumption as to the rate of appreciation of various types of assets, such as taxable bonds, tax-free bonds and equities. Equities have historically yielded the highest overall rate of return on investment, but when market conditions are down, bonds are often viewed as a safer investment. Historical data suggest that, over long periods of time, bonds can be expected to yield a return of approximately five percent per year (depending on interest rates), while equities will have an overall rate of return far in excess of five percent. To minimize risk, yet retain the potential for increased returns, most investment advisors recommend an investment strategy that includes both bonds and equities.

By utilizing the *actuarial arbitrage strategy* planners, charities and donors potentially eliminate market risk, investment risk and life expectancy risk.

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*family law, wealth transfer in business and retirement.*