Asset repositioning

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With interest rates at historically low levels, certain types of fixed interest rate financial assets may prove to be inefficient conduits for the transfer of wealth to heirs. These fixed assets include CDs, money markets, corporate bond funds and U.S. government securities. Yields on these investment instruments have declined dramatically, thus leading to shrinking levels of income for those who hold them. The current yields on these types of assets are also taxable for income tax purposes.

The question to ask is, *"Can a client use an 'asset repositioning' strategy to provide an increased income stream while transferring an equal or greater asset value to heirs?"*

The answer is yes. By transferring a low income yielding asset to a tax-efficient Single Premium Immediate Annuity (SPIA), the client can obtain a potentially higher guaranteed life income. By definition, a SPIA is the liquidation of both principal and interest over a life expectancy. This non-qualified SPIA will have an "exclusion ratio" where a large part of each annual guaranteed payment will be tax free and a small part of each annual payment will be taxable.

The part of the SPIA income not needed for current spending could be used to purchase a life insurance policy where cash values grow tax deferred and the death benefit is income tax free. The policy could be owned personally by the client or owned by an Irrevocable Life Insurance Trust (ILIT) created by the client. This plan could result in an increased amount inherited by the heirs when compared to the non-leveraged and taxable yields of the other fixed financial tools described earlier.

Case Study

The client is a 70-year-old widow and has been receiving Social Security retirement benefits. She has $300,000 of mutual funds allocated between corporate bonds and U.S. government securities with a current average yield of 3 percent. The client is in a 20 percent federal/state tax bracket and has seen her annual income from this yield decline from about $18,000 ($14,400 after-tax) in 2008 to only about $9,000 ($7,200 after-tax) in 2012. Her plan is to spend this after-tax annual yield and leave the current principal of $300,000 to her two adult children. Is there a way this client can increase her income back to her 2008 level while still providing an inheritance to her heirs?

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Solution

Liquidate the corporate bond/U.S. government securities mutual funds and place $300,000 into a SPIA with a life-only settlement option. The guaranteed annual payment of $21,750 from a competitive carrier has an “exclusion ratio” of 86.2 percent. So, in a 20 percent tax bracket, the after-tax annual amount is $21,150.

Client keeps $14,400 for spending, which gives her the after-tax amount she used to have for spending back in 2008 before interest rates started to fall sharply.

The remaining after-tax payment from the SPIA ($6,750) is allocated to an annual premium on a preferred no-lapse Universal Life (UL) policy with a face amount of $317,016 from a competitive carrier. She could be the policy owner with her two children as equal beneficiaries. The face amount is fixed at $317,016 and the insurance death benefit is income tax free.

Another alternative is to gift $6,750 each year to an Irrevocable Life Insurance Trust (ILIT) for the benefit of her children. Even though her gross estate should not have any federal estate taxes to worry about, state death taxes may be an issue. The $317,016 insurance proceeds paid to the ILIT will be free of state death taxes.

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”Benefits and other considerations using this SPIA

1) The repositioning approach requires that the mutual fund principal be liquidated and transferred to a guaranteed income stream.

2) Net after-tax income has been increased from $7,200 with the current mutual fund plan to $21,150 with the SPIA blueprint. Part of this increased after-tax income ($14,400) has been allocated to retirement spending. The remaining after-tax income ($6,750) has been allocated to an annual premium for an income-tax-free death benefit of $317,016.

3) Assuming death at age 90, the internal rate of return (IRR) on the death benefit is 7.58 percent. In a 20 percent tax bracket, the pre-tax equivalent rate of return is 9.48 percent.

4) Market risk and interest rate risk has been reduced by transferring the mutual funds to a combination of guaranteed income stream from the SPIA and a guaranteed no-lapse UL insurance policy.

5) The net inheritance to the client’s children has been increased from $300,000 under the non-guaranteed and taxable mutual fund plan up to $317,016 under the guaranteed and income- tax-free insurance arrangement.

It’s important to note that continued payment of the no-lapse Universal Life policy premium all the way until death is critical to the success of the plan. Due to the actuarial structure of a no-lapse Universal Life policy where little or no cash value accumulates in the policy, non-payment of the annual insurance premium could result in a lapse of the policy during the lifetime. A lifetime lapse would seriously undermine the financial advantages of the combined SPIA/Universal Life plan presented here.

Further, the client should be in a financial position where the use of existing liquid assets to purchase the SPIA will not compromise his or her retirement lifestyle. It's important to project fixed retirement expenses with an inflation factor to determine if the overall plan can sustain itself out to life expectancy and beyond.

The best way to determine whether the plan presented here is feasible is to gather accurate client financial data. This can be accomplished by obtaining a good asset inventory from the client with a conservative rate of return assigned to each asset. The financial service professional should gather a listing of all the client's assets and the future purpose for which the client intends to use each of those assets.

Only assets that will clearly not be needed for future fixed retirement expenses should be used to purchase the SPIA. Remember, with a SPIA you are cashing in the principal of a financial asset and transferring the resulting cash to a SPIA in exchange for a guaranteed income stream from the annuity carrier. The resulting "asset repositioning" can increase spendable cash flow to the client while still preserving asset principal in the form of tax-free life insurance death benefits.