Enhancing a Charity's Cash Flow

Charities are not immune to market fluctuations, and many charities likely found themselves impacted by the market downturn of 2008. As a result, it's likely that many charities now find themselves experiencing a significant decrease in revenues, such as donations and investment income. As a result, some of them may need to convert significant portions of their endowment to cash to meet current cash flow needs to sustain their charitable purposes. This provides a unique opportunity for you to help charities enhance their endowment income by implementing an annuity arbitrage plan.

This approach may work best when a charity possesses a low-risk, low-yield fixed rate asset and is using the income provided by the investment to fulfill its charitable purpose.

How Does an Annuity Arbitrage Plan Work?

The charity liquidates the asset and purchases a single premium immediate annuity (SPIA) with the sale proceeds. The SPIA provides income to the charity for the annuitant/insured's life that may be higher than the charity was earning on the original investment. Because the charity is a nonprofit, it pays no income tax on SPIA payments during the annuitant/insured's life.

The charity uses the SPIA payments to purchase a guaranteed life insurance policy on the annuitant/insured's life to replace the SPIA deposit. The charity is the owner and beneficiary of this insurance contract. At the annuitant/insured's death, the SPIA is discontinued and the life insurance proceeds are paid to the charity. In certain cases, the SPIA payout may be enhanced with a traditional annuity arbitrage approach.[1]

Hypothetical Case Study: XYZ Charity

XYZ Charity's Concerns

XYZ charity's assets include $1 million in a fixed account that it expects to generate an annual percentage yield of 2 percent. Due to shrinking revenue and donations, the charity would like to increase the income on these assets. Four board members, each with an established pattern of giving to the charity, would like to assist in any way possible.

Footnote

[1] The SPIA payout may be enhanced by taking advantage of differences in the underwriting ratings of different insurance carriers for the same person. For example, a person with standard health may be able to obtain a "preferred" rating from one carrier but a lower "standard" rating from a different carrier. The charity capitalizes on the underwriting rating variances by purchasing a SPIA from the carrier offering the less favorable rating and, at the same time, acquiring a life insurance policy from the carrier offering preferred rates.

XYZ Charity's Strategy

By purchasing four $250,000 SPIAs with the $1 million and purchasing a guaranteed life insurance death benefit of $250,000 insuring each of the board member's life, the charity may increase its current cash flow on these assets. The charity would replace the SPIA deposit at each board member's death.

XYZ CHARITY'S POTENTIAL RESULTS[2]

Age	SPIA Deposit	SPIA Payout	SPIA Payout Rate	Life Premium	Net SPIA Cash Flow	Net Cash Flow Rate	Current Cash Flow	Increase	Percent Increase
55 M	$250,000	$15,066	6.03%	$3,737	$11,329	4.53%	$5,000	$6,329	126.57%
65 M	$250,000	$17,567	7.03%	$6,498	$11,069	4.43%	$5,000	$6,069	121.39%
70 M	$250,000	$19,884	7.95%	$8,782	$11,102	4.44%	$5,000	$6,102	122.04%
75 M	$250,000	$22,939	9.18%	$11,899	$11,040	4.42%	$5,000	$6,040	120.79%
Total	$1,000,000	$75,456	7.55%	$30,916	$44,540	4.45%	$20,000	$24,540	122.70%

Footnote

[2] Assumes XYZ charity has an insurable interest in each board member's life. Hypothetical SPIA payout rates and life insurance premiums are based on standard non-smoker underwriting class. Life insurance premiums assume guaranteed death benefit equal to the amount of the SPIA deposit. All guarantees are subject to the claims-paying ability of the life insurance carrier. Cash flow from current investment assumes annual percentage yield of 2 percent. Hypothetical example for illustrative purposes only. Individual results will vary. SPIA payments are fixed for the annuitant's lifetime. Once SPIA payout has begun, the charity may not surrender the contract for a cash value.

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