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Using Life Insurance to Supplement Retirement

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There are three basic strategies I've seen employed by people when it comes to saving for their retirement.

First, those that do nothing and wake up one morning in their 50's or 60's and realize they made a mistake in not having had some sort of a systematic method to save a portion of their current income during their working years to have it grow and be available for their retirement.

Second, there are those that are content with putting away what they're either able or allowed to put away in their IRAs, 401(k) plans, or 403(b) plans and use the traditional retail stocks, bonds, mutual funds, or ETF's to grow their investments.

Third, there are those that look to supplement the maximum contributions to their current 401ks, 403bs, or even their corporate pension/profit sharing plans. In my practice these high wage earner practitioners, key executives, or business owners will often set up a nonqualified Deferred Compensation Plan (DCP), a Supplemental Executive Retirement Plan (SERP), or a Supplemental Owners Retirement Plan (SORP), to deposit funds over and above their allowable limits using various types of life insurance policies to diversify their portfolios. Although they don't get a tax deduction, they do so to take advantage of the specific benefits found in a life insurance product that we'll discuss.

In addition, there are those that use a life insurance policy not only for its death benefit but also as an ''Asset Class'' for its ''Living Benefits.'' As an investment vehicle life insurance allows assets to grow and accumulate on a tax deferred basis and also allows the owner/insured, at a time of their choosing to distribute the accumulated cash value on an income tax free basis. This is done through annually surrendering the cash value up to basis, and then borrowing the excess cash value through annual loans that are not taxable and will never have to be paid back as long as the life insurance policy survives the insured.

DEFERRED COMPENSATION PLAN FOR KEY EMPLOYEES OR PRINCIPALS

Often times an owner of a business or professional practice will incorporate a DCP in order to retain a key employee using the symbolic ''Golden Handcuffs'' with the unsecured promise of a death benefit for their beneficiaries along with a side fund that will one day be withdrawn income tax free to supplement their retirement assuming the executive meets the criteria in the DCP.

The two primary investment funding methods for DCPs, SORPs, and SERPs are either traditional stocks, bonds, etc., or a life insurance policy. For purposes of this article, we'll be discussing various life insurance policies that build up significant cash value. The policies of choice to fund either of the above plans are Whole Life (WL), Indexed Universal Life (IUL), and Variable Life (VL), as they are all intended to take advantage of a policy's ability to accumulate its cash value for a prolonged period of time.

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DISTRIBUTION OF ACCUMULATED DEFERRED ASSETS

Let's look at a typical situation in which an employee, or owner aged 40, might consider a DCP to provide a supplemental retirement income for when they retire in say 20 or 25 years regardless of how much they may have already contributed to their IRA, or any other type of retirement plan. For example, the employee could choose to defer $25,000 of their income in a DCP, funded with a life insurance policy with a $1 million death benefit that will continue to grow on a tax-deferred basis until they reach a desired age. At that point, the employee, assuming he/she was a nonsmoker and in good health, would have paid in $500,000 after 20 years. Then on the 20th or 25th year, at age 65 or 70, the employee could begin to draw out an annual income, including the gains, all on a tax-free basis assuming the policy survives the insured. One of the main reasons life insurance funding is to strategically design the policy to accomplish the above stated objective based on a degree of risk an owner wishes to take.

TAX BENEFITS

There are particular tax benefits to a DCP depending on whether the entity offering the DCP is a C corporation, a subchapter S corporation, or a limited liability company. The entity type will determine whether the employer selects a traditional plan, which the employee pays for and owns the policy himself. Or whether a nontraditional plan is used, in which the employer will make a loan to the employee, and by using a split-dollar arrangement, will still allow the employee to take a tax-free distribution.

LIVING BENEFITS

Estate planners have primarily used life insurance to provide for the payment of estate and other transfer taxes using discounted dollars. In addition, insurance has also been used to provide a source of tax advantaged supplemental income. Today they are also able to use the death benefit to pay for qualified long term care expenses on a tax-free basis. It is now far more common for life insurance professionals to do planning with products such as Private Placement Life Insurance (PPLI), and IUL policies for entire segments of the upper income and high-net worth marketplace of consumers.

IUL AND PPLI LIFE INSURANCE FOR HIGH-NET WORTH (HNW) AND ULTRA HIGH-NET WORTH (UHNW) CLIENTS

The most simplistic explanation of IUL is that it is a version of universal life but rather than have a stated interest rate like traditional UL, a guaranteed premium and death benefit similar to guaranteed UL, or have investment sub accounts like VL, IUL is classified as a fixed product with crediting linked to an index, most commonly the S&P 500 Index. It is postured as a product with upside potential without the downside risk. For example, the crediting of cash value in an IUL product may have a cap of 10% with a floor of 0%. This means that when the Index is up 10% or more, the policy crediting is only 10%. However, when the index is negative, the policy is credited with 0% and the client won't lose any money as a result of the negative return. When the return is between the two, the policy is credited with that return.

The UHNW clients are now far more interested in acquiring life insurance policies as an asset class that provides favorably taxed income distributions, as well as income and estate tax free death benefits to meet their estate tax and wealth preservation objectives. This comes as a result of a unique life insurance strategy which now allows a larger amount of accumulated cash value to grow and accumulate tax deferred indefinitely despite the recently enacted SECURE Act.[1] Recent changes to I.R.C. §7702, and the full-frontal onslaught that the UHNW client faces as a result of the current tax environment, have made PPLI even more efficient than it was just last year. Equally significant, is that PPLI offers better pricing and lower costs due to a host of factors which the insurer in turn passes on to the insured. These factors, in addition to significantly reduced institutional rather than retail commissions, result in a larger cash value buildup and unlike their retail counterparts have no early withdrawal nor surrender charge penalties. Transaction fees are curtailed by the use of a hedge fund manager which can provide a more cost-efficient outcome. Although the policy has a death benefit it primarily acts as an accumulation vehicle for the HNW client wishing to allocate a large premium with the ability to later distribute income to the owner on a tax-free basis. Although there are no guarantees with a VL insurance product, such a product in my practice is primarily used by those that significantly overfund the necessary premium and in doing so, use the policy as a accumulation vehicle thus preventing the policy from lapsing prematurely. In addition, I make them aware of the heightened market risk in using a VL insurance product.

CONCLUSION

Various types of life insurance products can be used to diversify existing traditional stock and bond portfolios with the ability to reduce market risk by offering

[1] Pub. L. No. 116–94.

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various guarantees against a loss of principal. Since there are no income limitations as there are in a Roth IRA, any gains are unaffected by the SECURE Act and can continue to grow tax deferred for as long as the owner wishes. Then if set up correctly, he/she can distribute all of those proceeds income tax free. At death, all life insurance policies pay out a leveraged death benefit, which if set up correctly, is income and estate tax free. One of the more important ''Living Benefits'' is the ability to add a long-term care rider to a life insurance policy, which as a result of the Pension Protection Act,[2] allows an insured immediate access to withdraw up to the full death benefit to pay for any qualified long term care expenses income-tax free.

While PPLI offers access to institutional hedge funds rather than traditional retail mutual funds, as well as various other significant features and tax advantaged income benefits, it is a registered security. As such it requires an experienced team consisting of an attorney, an accountant, and an independent insurance professional to properly structure and maintain such an arrangement, so it can be costly to set up. However, when properly implemented for the right client, the benefits far outweigh the initial costs.

[2] Pub. L. No. 109-280.

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