

Double Duty Dollars of Life Insurance: The Art of Tax-Free Retirement Income

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If I could describe life insurance in one word it would be “flexible.” A permanent life insurance policy provides the policy owner with a combination of death benefit protection and income distribution that are unmatched by any other product.

Life insurance death benefit proceeds are generally excludable from the beneficiary’s gross income for income tax purposes. There are few exceptions, such as when a life insurance policy has been transferred for valuable consideration. But the potential income distribution is equally significant because of the tax advantages that apply to a policy’s cash value.

Accessing the cash surrender value

The total premium paid into the life insurance policy is the cost basis of the contract. For our discussion, we assume the premium paid is not so high as to convert the policy to a modified endowment contract.

A withdrawal from the policy cash surrender value is treated as a return of premium first and taxed as gain only after total withdrawal exceeds the total premium paid for the life insurance policy. Thus, to avoid tax on the gain, the policy owner would take a policy withdrawal only up to the total premium paid—the policy cost basis.

The policy owner could take a policy loan for distributions in excess of the policy cost basis. The policy loan is not subject to income tax so long as the contract remains in force. Loans and withdrawals will reduce the death benefit and cash surrender value, and may cause the policy to lapse.

Loan interest must be either paid or accrued in the policy. The risk is that the entire outstanding loan could be taxed as income to the policy owner if the policy lapses or is surrendered during the insured’s lifetime. If this risk is acceptable to the policy owner, then policy distributions could potentially be made without incurring an income tax, as long as the life insurance policy remains in force.

For these reasons, many businesses use life insurance as an informal funding source for non-qualified executive benefit programs, such as salary deferral plans and supplemental executive retirement plans (SERP). The policy cash surrender value growing tax deferred is an asset on the business’ books. And the policy is often used to offset the growing liability for the future retirement benefit to be paid to the executive.

The business can make a policy withdrawal or a loan from the cash surrender value to recover the after-tax cost of the retirement benefit in the year it is paid to the executive. Lastly, the business can use the life insurance policy death proceeds to recover all costs associated with the plan. Businesses using life insurance in a deferred compensation plan is an

example of using all the tax benefits that life insurance offers. If businesses can take advantage of these tax benefits, why shouldn't individuals?

For example, let's consider Bill Smith, a 45-year-old male preferred non-smoker living in Pennsylvania. Bill works with his broker to structure a universal life insurance policy that provides death benefit protection for his family and the potential for income at retirement.

The face amount would be the minimum necessary to keep the policy from becoming a MEC. Bill would pay \$10,000 of annual premium for 20 years either using after-tax income he has already received or through a formal bonus plan implemented by his employer. Bill would be the insured and the policy owner.

If the policy were to receive a credited interest rate of 5.30% in all years, then beginning at his age 65 (year 21), Bill could make annual distributions of over \$23,000 from the life insurance policy cash value for 15 years. Distributions would be in the form of withdrawals up to cost basis (\$200,000), then as policy loans thereafter. Loan interest would be accrued and supported by the policy. In this scenario, Bill could receive distributions exceeding \$350,000, including the distributions in excess of the \$200,000 cost basis—without incurring income tax.

When reviewing the policy each year with his life insurance agent, Bill could increase or decrease the annual premium to fit his cash flow. The future policy values and distributions will reflect the impact of those adjustments. Bill may be near retirement and determine he does not need income

from the life insurance policy and that he would like to use the policy for death benefit needs instead.

The death benefit is projected to reach \$1,000,000 when Bill is in his late 80s if he takes no distributions from the policy cash value. Or Bill can take a distribution from the policy cash value in some years but not in others as needed. By using his premium dollars as double-duty for death benefit and income, Bill has built-in flexibility for the future.

Prospects for this approach include individuals between the ages of 40 and 60 who are already contributing the maximum to their qualified plan and want additional options to supplement retirement savings, plus death benefit protection. Business owners, particularly S-Corporation owners, would also be good candidates for this approach. They may desire to build a retirement plan for themselves inside their company. But due to tax limitations, they may be better served structuring an arrangement outside of their company.

Permanent life insurance provides valuable benefits. Beneficiaries receive the death proceeds income tax free and the policy owner can access the policy cash value tax favorably. Individuals should consider purchasing a permanent policy if the potential for additional income in the future is a goal. The life insurance premium paid is truly doing double-duty with the potential for tax-free income.

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