Using Cash Value Life Insurance for Retirement Income

By Steve Parrish *Thu, Nov 19, 2020*

Cash value life insurance can be a versatile tool in the hands of a diligent financial advisor, writes our guest columnist, an Adjunct Professor of Advanced Planning at The American College of Financial Services.

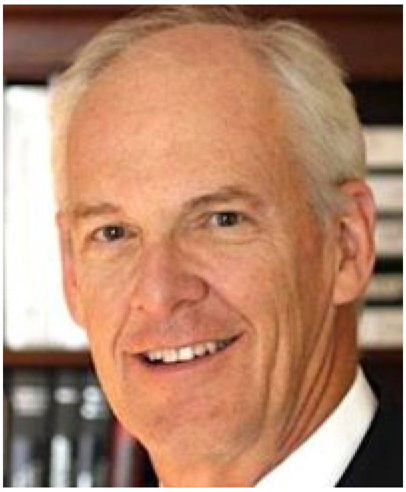
Can cash value life insurance provide a useful retirement income supplement? It depends on whom you ask. Thirty years ago, I purchased a high cash value whole life policy, using my annual bonus to pay each year's premium. When I reached retirement age, I made a tax-free exchange of the policy values into an immediate annuity that pays out a lifetime income for me and my wife.

But it doesn't necessarily work for everyone. I met a physician recently who complained that an agent had sold him a "basket full of whole life policies" to generate tax-free income in retirement. The agent vanished, so the doctor surrendered the policies, paying a hefty tax on the gain.

There was a big difference between my situation and the physician's, however. My policy was part of a retirement plan. His resulted from a life insurance sale with apparently little follow-up. Too often, life insurance is merely a sales idea with no real follow-up once the policy is delivered. Life insurance as a retirement strategy requires ongoing communication and administration.

While most retirees use life insurance for its death benefit, cash value life insurance policies can:

- Serve as a source of funding during the insured's lifetime and a strategy in retirement planning.
- Pay out a tax efficient stream of income for a period of years through withdrawals and loans.
- Supplement an individual's retirement income when heavily funded;
- Fund a non-qualified deferred compensation benefit for an executive (when a corporate owned life insurance policy, or COLI;
- Buy out a retiring owner's stock in buy-sell situations.



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In this article, I propose that advisors use this **checklist,** or one like it, to assure proper execution of the plan. Any checklist should cover the acquisition of the policy, the implementation of the plan during pre-retirement years, and the decumulation of values during retirement. Ongoing administration of the plan and attention to detail are essential.

Policy acquisition

Clients, whether individual or corporate, will need help choosing an appropriate policy, both in terms of its use and its risks. For example, a variable universal life (VUL) policy requires more education and decision-making than does a whole life policy. With VUL policies, the policyowner controls the investment of the cash value. With whole life, the insurer controls it.

The advisor must also ask if the policy design fits the intended investment *risk strategy* for the client's retirement plan. The advisor should also confirm whether the retirement strategy will use the policy as an uncorrelated buffer asset (a case for whole life) to mitigate sequence risk or, as vehicle for tax deferral (a case for VUL).

Another important question: Is the contract flexible enough? For example, if the owner wants a monthly retirement income when he or she starts decumulating the policy, can the insurer automate these payments? A written withdrawal request to the insurer every month would be unwieldy.

The advisor also needs to determine if the policy has the right triggering points to accomplish the retirement strategy. If the purchaser plans to use the policy for a voluntary retirement, many cash value products will work. If, however, the policyowner wants access to payments for disability or long-term care, the policy will require additional riders or policy features.

During the policy acquisition process, it will be hard to tell how the policy will perform. Cash value life insurance designs are often difficult to understand, and the illustrations vary by product type. For example, from a regulatory standpoint, a whole life policy uses a different illustration regime than, say, an indexed universal or variable universal policy. Some policies are considered securities under state and federal law; others are not. This can lead to apples-to-oranges comparisons. An advisor will need to take extra steps to explain and demonstrate the life insurance retirement income strategy to a prospective client.

The purchaser must also determine how the policy strategy will integrate with the client’s overall portfolio and plan:

1. In a buy-sell situation, the business needs to determine from the outset whether the policies will be owned individually by the business owners (a cross purchase buy-sell) or by the business itself (an entity buy-sell).
2. In an individual retirement situation, the prospective retiree should coordinate policy withdrawals and loans with their overall asset location and income withdrawal strategy. If the cash value withdrawals provide an income bridge while the owner defers filing for Social Security, the policy funding must have sufficient cash values for that purpose.
3. In a non-qualified deferred compensation situation, the company will typically own variable life insurance policies. They will want to match, at least roughly, the policy’s sub-accounts with the investment crediting strategy for the participating executives. Otherwise, the company’s liability to its executives won’t match the funds in the policies.

Plan implementation

Before any policy is actually issued and placed, certain legal issues must be addressed. When life insurance is used to buy out a retiring owner of a business, at least three legal issues arise.

First, to avoid income tax on a transfer for value, the advisor must determine if the business will own the policy or if it will be cross-owned by a business owner. If the policy is corporate owned, the notice and consent formalities of IRC Section 101(j) should be considered. Finally, the existence of the policies and their intended use should be documented in the buy-sell agreement.

If the life insurance will reside in an irrevocable life insurance trust, the policy should be issued, not transferred, to the trust in order to avoid estate inclusion under IRC 2035. Beneficiary designations should likewise be determined in advance.

While buying life insurance always requires the expertise of a licensed agent, help from attorneys and accountants will likely be needed to implement the plan. One of these professionals needs to be responsible for using a checklist to coordinate their activities.

Plan administration

When life insurance-based retirement strategies break down, poor administration and communication is often the cause. When a licensed insurance agent receives a heaped commission for placing the policy, that can be a disincentive to ongoing administration.

While the client's attorney may be on retainer, he or she may not have the technical expertise to administer the life insurance plan. In some cases, execution of the plan may require the services of a specialist who earns a separate fee for services provided.

Other primary elements to include in a checklist for proper plan administration are:

- Monitoring and reviewing the plan with the client and other professional advisors
- Establishing triggers and procedures for implementation of the strategy upon the insured's retirement
- Determining the amounts and timing of withdrawals when the policy is ready to be used for retirement income

In an individual client scenario, for example, the insured owner may choose to target policy withdrawals to avoid adding to taxable income (thus avoiding the NII tax, Medicare Part B increases, or Social Security covered compensation tax). In a corporate situation, the company's advisor should determine which is more or less expensive: To access policy values or use the company's own capital. If capital is inexpensive, waiting and using the life insurance for its death benefit may be better.

Once income withdrawals begin, the advisor should find out if the life insurer can automate the withdrawals. For example, can premiums cease and monthly payments begin automatically? When decumulation of a universal life policy begins, the owner should ideally switch from an increasing death benefit to a level one. This is often a predetermined step. It maximizes the value of the life insurance in retirement income planning. Who will be responsible for making this switch?

Further, withdrawals of the cash value should be made only until the owners recover their tax basis, and they should take future drawdowns from the policy as loans. If the insurer doesn't offer these services, the advisor will need to help.

Every plan will need lifelong monitoring. The insurance company should be monitored for impaired financial ratings, mergers, or changes in its internal pricing of in-force policies. Tax law changes should be examined for effects on the retirement plan. And, of course, the client's individual situation should always guide the execution of the plan. The life insurance policy ultimately represents a death benefit, and a change in the insured's health status may alter the decision to use the death benefit or the cash value strategy.

Advisors will have their own approaches to fulfilling their duties related to a client's retirement strategies. For the use of cash value life insurance in retirement planning, this checklist may be a useful tool. Applied throughout the period of accumulation and decumulation of the cash value life insurance contract, the checklist will help ensure the success of the retirement strategy.