

AICPA Wealth Management Insider



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Life Insurance in Retirement Plans

The use of life insurance in pension plans has been a debated subject. Here's a top-level summary of pros and cons of life insurance in various pension plan scenarios.

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Life insurance in pension plans has long been a subject of debate, and many insurance agents, attorneys and CPAs on both sides believe zealously in their respective positions.

In reality, most uses of life insurance in pension plans are fairly inadequate, some are downright abusive and have caused IRS scrutiny, and only a few are truly astute strategies of tax/life insurance planning.

Generally, retirement plans are of two kinds:

1. **Defined-contribution plans** (profit-sharing plans) define the amount of contribution, and the retirement benefit is a function of investment performance.
2. **Defined-benefit plans** define the amount of retirement benefits, with the contributions, conversely being a function of the investment performance.

Generally, a life insurance policy owned by a pension plan isn't the great deal its proponents claim to be, but it isn't appalling either. There are disadvantages and advantages, and the final analysis depends on what is most important to your client. What isn't always noticed by debaters of life insurance in pension plans is that they are concentrating mostly on the tax-deductible nature of the life insurance premiums without focusing as much on other issues. In short, there are both objective and subjective reasons.

Defined-Contribution Plans

A short summary of factors concerned with life insurance being owned by a defined-contribution pension plan:

- Up to 50 percent of annual pension contributions can be used to pay premiums for Whole life insurance and up to 25 percent for Universal life insurance premiums. These premiums, being part of the pension contribution, are fully tax-deductible.
- The **economic benefit**, equivalent to actuarially determined term insurance costs, is included in income, and the insured pays personal income tax on that amount, which increases with age.
- Premiums can be paid with "seasoned" assets, not just with the current year's contributions.
- If the insured dies while participating in the pension plan, the death benefits are income-tax free, but the cash values are fully taxable, less the cumulative term insurance costs incurred, which creates basis in the policy. For example, if the death benefit is \$1 million and the net cash-value is \$200,000, then \$800,000 is not subject to income taxes and \$200,000 is taxable as pension distribution reduced by the cumulative imputed mortality (term) cost. Life insurance proceeds are included in the insured's estate, and are subject to estate taxes.
- If the assets in the pension plan are transferred to an individual retirement account (IRA) at retirement, which is very common, the life insurance policy must either be terminated or distributed to the insured. If it is distributed, its value (usually the cash value) is fully taxable.

So on one hand there is tax-deductibility for the premiums being part of the pension contribution. But on the other hand, the investment yields will be lower within the life insurance policy because permanent life insurance expenses are very high. Performance yields for a life insurance investment are similar to municipal bonds. The investment and the tax benefits associated with life insurance ownership are largely negated by the tax-deferred treatment of the retirement plan. Nobody would think of buying municipal

bonds with pension money even though it is not expressly prohibited. Then why would your clients buy life insurance inside of their retirement plan for investment purposes? The answer lies in the fact that life insurance is not a suitable investment for pensions. The policy is purchased for its insurance component.

Another potential problem is the exposing of death benefits to estate taxes because they are included in the insured's estate. However, this can be avoided with a policy that is owned outside the insured's estate.

The third potential problem is prematurely paying taxes on the policy's cash value if it is distributed to the insured at retirement because the pension assets are rolled into an IRA.

When all of these factors are considered, most individuals would avoid having life insurance owned by their defined contribution plans.

Not only should a full assessment be done for anyone contemplating the purchase of life insurance in a defined-contribution plan, but an assessment should be done for individuals with life insurance that is currently owned by a defined-contribution or profit-sharing plan. Assessing an existing policy is more complicated because full consideration must be given to the impact if your client wants to remove the policy from their pension plan. Sometimes it will be best to purchase a new policy and then terminate the policy in the pension plan, and other times it will be best to withdraw and leave in the pension plan as much of the cash value as possible and then distribute the policy out. Among the considerations is the kind of policy (i.e., whole, universal or variable life) and whether any of the transactions will trigger penalty taxes.

Defined-Benefit Plans

At the pinnacle of abuses of using life insurance in pension plans lies a group of strategies that utilize clever actuarial assumptions. There are a number of abusive defined-benefit plans that only use life insurance funding. These are Section 412(i) plans. Generally, Sec. 412(i) plans are legitimate defined-benefit retirement plans that use life insurance and annuity funding. But the potentially abusive plans claim extraordinarily higher tax-deductible contributions than legitimate plans, and have grossly higher life-insurance amounts. These possibly abusive Sec. 412(i) plans are designed for the participant-insured to then purchase the life insurance policy after a short period of time, usually five years, for a substantially understated amount. This is what the promoters claim creates a huge tax break. The IRS has clearly signaled that they are looking for these plans, and they may deny excessive contributions and tax them instead as dividends. The IRS may also impose sanctions such as plan disqualification, penalties, and interest.

Conclusion — Where It Does Work

There are at least a few situations in which having a pension plan own life insurance is utmost appropriate planning.

- 1. Your client can't afford the cost of permanent protection.** Considering current economic conditions, it may be a viable option to have the plan own the policy originally with the intent to distribute it in the future.
- 2. Your client is in poor health and is highly rated.** The cost of economic benefit taxable to your client is generally lower than the cost of protection paid with after-tax dollars.
- 3. Your client is over 70-years-old and the policy represents value significantly in excess of its cash surrender value in the secondary market.** In this situation you have positioned the life insurance policy as an asset owned by the plan, where the policy itself is an investment and is treated speculatively. As an example, a \$1,000,000 life policy on a 75-year-old participant with a cumulative five-year premium outlay of \$150,000 and a \$50,000 cash-surrender value, may have a secondary value well in excess of its surrender value, thus providing plan participant with an attractive cost-benefit ratio in the event the policy is sold.

As with all tax-related matters, careful consideration of long-term consequences to the client should be weighed against immediate short-term results.

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