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Using Cash Value Life Insurance for Retirement Savings

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What is using cash value life insurance for retirement savings?

One of the more popular uses for cash value life insurance is to save for retirement. Cash value life insurance refers to a wide variety of insurance policies that provide both a death benefit and the potential accumulation of cash value over a period of time. Cash value life insurance can range from a traditional level premium whole life policy to a single premium whole life policy to a universal life policy to a variable life insurance policy or a variable universal life policy . In today's insurance marketplace, there are a wide variety of cash value life insurance policies that a consumer can buy. These types of insurance policies are in contrast to a term life insurance policy in which the insured makes a series of premium payments and the beneficiaries collect the death benefit if the insured dies while the policy is still in effect. There is no buildup of cash value with a term life policy.

Many people use a cash value life insurance policy to save for their retirement and to provide a death benefit to their beneficiaries. In very rare instances, companies may offer their employees an option under their retirement plan to purchase life insurance. Under a qualified retirement plan, amounts contributed to the plan by the employer will be tax deductible. Any increases in the cash value part of the policy due to investment or interest gains will be tax deferred until the money is withdrawn from the policy. Some people will also use a cash value life insurance policy as a supplement to a qualified retirement plan. If you work for a company that does not offer a qualified retirement plan (or does not offer a life insurance option in an existing plan) or if you have already contributed the maximum amount to your qualified retirement plan, a cash value insurance policy can offer some of the tax benefits of a qualified retirement plan. Although the payment of the insurance premiums is not tax deductible, any increase in the cash value of the insurance policy due to investment gains is not taxed until you begin to withdraw the money after you retire. The cash value grows tax deferred (like an annuity). Furthermore, the withdrawals may not be taxable if you utilize the tax-favored withdrawal provisions cash value policies offer.

Caution: *Some cash value life insurance policies do not offer a guaranteed return (e.g., variable universal life). These policies may gain or lose value based on the performance of the underlying investments. Variable life and variable universal life insurance policies are offered by prospectus, which you can obtain from your financial professional or the insurance company. The prospectus contains detailed information about investment objectives, risks, charges, and expenses. You should read the prospectus and consider this information carefully before purchasing a variable life or variable universal life insurance policy.*

Caution: *Any guarantees associated with payment of death benefits, income options, or rates of return are based on the claims-paying ability of the insurer. Policy loans and withdrawals will reduce the policy's cash value and death benefit.*

When is a good time to use cash value life insurance for retirement savings?

To provide family members with a death benefit and to save for retirement

Use a cash value life insurance policy for retirement savings if your goal is to provide life insurance for your family, as well as save for retirement in one combined effort. A cash value life insurance policy consists of two parts: a life insurance part and an investment part. Although there is only one premium for the total insurance policy, the premium paid each year is divided between the payment for the insurance and the payment for the investment savings.

Life insurance

Consider purchasing a cash value policy if you have a need for life insurance. To determine this need, consider the following factors. First, are there dependents (e.g., a spouse, children or elderly parents) who rely on your income to maintain their standards of living? If so, an appropriate life insurance policy can provide for your dependents in the event of your premature death. Second, if you are a non-income earning spouse, do you provide services that your spouse would otherwise have to pay for (e.g., child care, housekeeping, cooking, etc.)? Then you may need life insurance as well. Third, do you have such a large estate that substantial estate taxes will be incurred upon your death? Life insurance may be an excellent way to provide this liquidity to your heirs.

What are the strengths of using cash value life insurance for

retirement savings?

Protection from financial uncertainty

One of the main strengths of using cash value life insurance for retirement savings is to protect your family from financial uncertainty in the event of your premature death. Saving for retirement by buying mutual funds or Treasury bills or by simply investing your money in a savings account at the bank, is one approach, but then if you need life insurance you will have to buy a separate (perhaps term) policy. By purchasing a cash value life insurance policy, allows you to combine life insurance protection for your family with an investment component for your retirement. However, the cash value portion of life insurance policy is not like a savings account. It is not backed by the Federal government (FDIC insured), and it may experience gains or losses based on the performance of the underlying investment. Also, cash value life insurance may impose charges and expenses that can reduce your cash value.

Premiums may be tax deductible

If your employer offers the option to purchase life insurance through the company's qualified retirement plan, then, within limits, your (and your company's) tax-deductible contributions into the retirement plan may be used to purchase the insurance policy. Thus, using a cash value life insurance policy to save for your retirement can be an excellent way to buy a substantial life insurance policy on your life and save for your retirement, all for a discounted cost.

Caution: *Very few companies offer the option to purchase life insurance through their qualified retirement plans. There are complicated rules and limits that must be followed to offer life insurance through a qualified plan. Furthermore, there is extensive paperwork that must be completed. Many companies simply do not want to go through the effort to offer this option to their employees. Furthermore, many types of qualified retirement plans (such as IRAs and savings incentive match plans for employees) do not allow life insurance to be purchased through the plan.*

Policy values grow tax deferred

Another benefit to using cash value life insurance to save for your retirement is that the cash value part of the policy grows tax deferred. In this respect, a cash value life insurance policy is similar to an annuity. The cash value portion of the policy grows tax deferred until you begin to withdraw the funds or surrender the policy. Because the cash value grows tax deferred, some people will use a cash value life insurance policy as a supplement to a qualified retirement plan. If your company does not offer a qualified retirement plan or if you have already contributed the maximum amount to your qualified plan, then purchasing a cash value life insurance policy will give you some of the tax benefits of a qualified retirement plan. Although the premiums will not be tax deductible, the increase in the cash value due to interest and investment gains will not be taxed during the accumulation years.

Caution: *The current cost of the insurance protection of a life insurance policy held in a qualified plan is taxable as income to the employee.*

Cash value may be withdrawn

You may be able to withdraw some of the cash value from your life insurance policy (depending on the type of policy). The money can be withdrawn at any time, subject to the terms of the policy. As long as you maintain enough cash value in the policy, you can withdraw the cash from the policy and still keep the life insurance in effect to provide a death benefit for your family.

Cash value can be borrowed against

You can also borrow against the cash value in your insurance policy. The cash value that has built up in the policy is the collateral for the loan. The interest rate on the loan is determined in advance and is often below rates offered by banks.

Caution: *If you die before the loan is fully paid off, the amount of your death benefit is reduced by the amount of the outstanding loan (including interest). Furthermore, the policy must remain in force to maintain the favorable tax treatment of the loan.*

What are the tradeoffs of using cash value life insurance to save for your retirement?

The applicant must be insurable

An applicant must be deemed "insurable" by an insurance company in order for the insurance company to issue an insurance policy on your life. There are several factors that affect insurability; the two most important are age and medical history. The older you are and the worse your medical history, the more difficult and/or costly it will be to obtain life insurance. For example, a 45-year-old person in perfect health will pay substantially less for a comparable amount of insurance than a 65-year-old person who has already suffered a heart attack.

Cash value life insurance premiums are more expensive than term life premiums

Another tradeoff to using a cash value life insurance policy to save for retirement is that the premiums for a cash value policy are substantially more expensive than for a comparable amount of term insurance. The premiums are more expensive for a cash value policy because you are paying for both an insurance element and an investment element. With a term policy, you are simply paying for the insurance element (the death benefit). For example, a 40-year-old man in good health might pay $600 per year for a 10-year level premium $500,000 term life insurance policy. That same person might pay $6,000 per year for a cash value policy with the same death benefit. There may also be higher costs associated with a cash value life insurance policy (e.g., policy fees, higher commissions, premium expense charges, and surrender charges).

Purchasing power may be limited

The insurance company may limit the amount of insurance that an individual can purchase. If an applicant wants to purchase a very large insurance policy, the insurance company may require a justification of that amount of insurance (i.e., prove why that amount is necessary). The insurance company may consider factors such as income and assets. For example, if Ted earns $50,000 per year, the insurance company may not be willing to issue a policy with a $5 million death benefit on his life.

Cash value contributions may be limited

Because the cash value grows tax deferred, the federal government has passed laws and issued regulations limiting the amount of money that can be invested in these policies. If these limits are exceeded, the policy may not be treated as a life insurance policy for federal income tax purposes. This is a very technical area. Consult a tax planning professional more information on the limits on cash value life insurance policies.

Modified Endowment Contract (MEC) rules also limit size of cash value policies

Under federal law, if your premium payments into a cash value life insurance policy exceed certain limits , the policy is then permanently classified as a modified endowment contract (MEC) , and is subject to special taxation rules. Under these special rules, distributions, including policy loans , are taxable as income to the extent the policy cash value immediately prior to the distribution or loan exceeds the basis in the contract. A penalty may also apply to taxable distributions and loans. Consult a tax professional.

What are the tax implications?

Premium payments may be deductible

If your company offers the option to purchase life insurance through its qualified retirement plan, then, within limits, your tax-deductible contributions into the plan (and/or your company's contributions) can be used to buy the life insurance policy. Not many companies offer their employees the option to purchase life insurance through their qualified retirement plan. If you do not purchase the insurance policy through a qualified retirement plan, then the premiums will not be tax deductible.

Cash withdrawals in excess of basis are taxable income

When you begin to withdraw cash from a cash value life insurance policy (although only certain types of cash value policies allow withdrawals), the amount of withdrawals up to the basis in the policy will be tax free (the basis is the amount of premiums paid into the policy net of any previous dividends and tax-free withdrawals). Any withdrawals in excess of the basis will be taxed as income. If the policy is classified as a modified endowment contract, then withdrawals will be treated as first coming from earnings and, as a result, will be subject to income tax.

Policy loans are usually not taxable

If you take out a loan against the cash value of your insurance policy, the amount of the loan is not taxable (except in the case of a modified endowment contract). This result is the case even if the loan is larger than the amount of the premiums you have paid in.

Caution: *Such a loan is not taxed only as long as the policy is in place.*

Interest on policy loans are usually not tax-deductible

The interest on any loans taken out against the cash value of your life insurance is usually not deductible.

Surrender of policy may result in taxable gain

Like a policy withdrawal, if you surrender your cash value life insurance policy, any gain on the policy may be subject to federal (and possibly state) income tax. The gain on the surrender of a cash value policy is the difference between the net cash value and loan forgiveness amounts and your basis in the policy. Your basis is the total premiums you paid in cash, minus any policy dividends and tax-free withdrawals that you made.

Death benefits are usually not subject to federal income tax

Whoever receives the death benefits from your insurance policy (at the time of your death) usually does not have to include those proceeds in income for federal income tax purposes. One exception to this rule is if the insurance policy has been sold from one policyowner to another, subjecting it to the transfer-for-value rule . Another exception is that with respect to cash value life insurance held in a qualified retirement plan, a portion of the death proceeds equal to the cash value of the policy immediately prior to the insured employee's death will be treated as a plan benefit (not as life insurance proceeds) and therefore will be subject to income tax when distributed to a beneficiary.

Gift Tax

Policy proceeds are usually not considered a gift to beneficiary

The payment of death benefits to a beneficiary from a cash value life insurance policy on your life is usually not considered a taxable gift from you, although it generally is a transfer that is subject to estate tax. One situation where the payment of an insurance death benefit may be subject to the gift tax is when the owner, insured, and beneficiary are three different individuals--for example, when the husband is the owner of the life insurance policy, the wife is the insured, and a child is the beneficiary of the policy. Upon the death of the wife, the husband is considered to have made a gift of the insurance proceeds to the child. This gift may be subject to the gift tax.

Payment of policy premiums are generally not subject to gift tax

If you pay the premiums for an insurance policy on your own life, the payment of the premiums is not considered to be a taxable gift to the beneficiary of the policy. For example, Janet pays $5,000 per year in premiums for a $300,000 cash value insurance policy on her life. Her only child is the named beneficiary on the policy. The payment of this $5,000 premium is not a taxable gift from Janet to her child. However, if someone else pays the premiums for a policy that Janet owns, then the payment of those premiums is usually considered to be a taxable gift. The gift tax may apply if the annual premiums exceed the annual gift tax exclusion amount. In general, the payment of life insurance premiums made on behalf of another will qualify for the annual exclusion from the gift tax.

Estate Tax

Insurance proceeds may be included in your taxable estate

If an insured hold any incidents of ownership in an insurance policy or their estate is the beneficiary of the policy, the proceeds from that insurance policy will be included in the taxable estate . Furthermore, if the insured makes a gift of an insurance policy within three years of his or her death, then the proceeds from that policy will be pulled back into the taxable estate. Incidents of ownership include the right to change the beneficiary, the right to take out policy loans, and the right to surrender the policy for cash, among other things.

IMPORTANT DISCLOSURES

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