Life Insurance for Your Retirement Plan?

By Gary Case

This column will focus on both individual and business retirement plans and some possible uses of life insurance within each type of plan.

Individual Retirement Plans: When people talk about their IRA, frequently they indicate that they would like to see the money go to their heirs. A major challenge facing that transfer is taxation of the IRA proceeds. With the exception of Roth IRA distributions, money drawn from an IRA is subject to income tax. Further, some distributions may also be subject to estate tax at the death of the owner, resulting in a reduction of as much as 70%-80% of the proceeds reaching the beneficiary.

One remedy is to purchase life insurance with IRA money. At any time, the government generally allows distributions from an IRA over the life expectancy of the owner without a penalty. This strategy, when properly implemented, can provide a substantial death benefit to heirs that may be free of both income tax and estate tax. Proper ownership of the policy is required to remove the death benefit proceeds from one's estate.

Business Retirement Plans: Life insurance can be used to fund either tax-qualified or non-qualified plans.

The Employee Retirement Income Security Act (ERISA) governs tax-qualified plans. Generally speaking, ERISA plans prohibit retirement plan contributions that favor owners or highly compensated employees over rank-and-file employees. Non-qualified plans are not usually subject to ERISA and as such allow businesses "carve out" who participates in the plan.

Many tax-qualified plans that use life insurance require the use of an actuary to determine the amount of contribution to provide a defined income benefit at an employee's retirement. When funding qualified plans, life insurance may represent up to 50% of the dollars contributed to the plan. "Fully insured" plans use a combination of life insurance and fixed annuities.

On February 13th, the IRS issued several Revenue Rulings that address the use of life insurance in tax-qualified plans. The essence of these rulings is that some policies are no longer acceptable because they abuse the intent of the law. Thus, businesses considering life insurance in 401(k), 412(i), or other tax-qualified plans should consult with a tax advisor prior to implementing their plan.

Non-qualified plans have long used life insurance as a funding vehicle, even though in most cases, income tax benefits are realized as benefits are paid as opposed to when contributions are made.

One notable exception to this general rule is known as a welfare benefit, or 419 plan, named after the section of IRS code that defines the plan. When properly structured, contributions to such a plan may be deductible when made. Since these plans can be rather complex, it is recommended that businesses considering them obtain counsel from tax, legal, and insurance advisors.

Even though life insurance can add a degree of complexity to a retirement plan, the benefits are real and may substantially enhance the desirability of both owners and employees!

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