Forbes

4 Ways to Maximize Life Insurance in Retirement Income Planning

10/8/18
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Life insurance is a fundamental risk management tool for a secure financial lifestyle.

Primarily, it functions as an income replacement insurance product during an individual's working years. In many cases, life insurance is set up to provide financial security for family members or to pay off liabilities in the event of an untimely and premature death. Because the likelihood of the death of the insured occurring during working years is relatively low, but the impact would be devastating, insurance is a perfect fit for the situation.

However, many people not only buy term insurance, but they also buy a permanent life insurance product. Permanent life insurance is different than term insurance as it offers the potential of an investment component or cash value in addition to life insurance coverage. Because these insurance products will last for life, past your working years and through retirement, it is important to think about permanent products as assets that can also help support a secure retirement.

While there are a number of ways to utilize life insurance in retirement, let's just look at four common and beneficial approaches:

1. **Retirement Income**
   There are a number of ways that life insurance could be used to support retirement income. First, one could execute a 1035 exchange of an existing policy into an annuity product to provide lifelong income. This would make sense if the person no longer needs a large death benefit but instead needs monthly income.

   Second, a policy could be surrendered for its cash value or sold on the secondary market to provide an influx of cash. The recent tax reform bill changed the way that gain is calculated for secondary market sales of life insurance, reducing the amount of taxable gain in the sale of most policies.

   Curtis Cloke, CEO and Founder of Thrive Income Distribution System, LLC, indicates that "utilizing 1035 exchanges for the premium tax basis recovery is incredibly important, especially for policies that had significantly higher premium payments for the life of the policy compared to the surrender value of the policy." Though a secondary life settlement may provide higher cash benefits than surrendering a policy, Mr. Cloke notes that "in certain fact patterns, the 1035 exchange to a properly selected income producing annuity could allow an engineered solution to recover the former tax-basis of all after-tax premium payments and create a superior solution as an alternative to a life settlement but both should be considered and tested."

2. **Non-Market Correlated Asset**
Cash value can also be used to support a more secure retirement. As long as the policy is a non-modified endowment contract (non-MEC), which most policies are, cash value can typically be withdrawn income tax free at the time of the withdrawal.

This enables retirees to tap into their life insurance cash value without increasing their tax liability. Tapping into cash value can be a useful way to get access to cash without dipping into investment assets during a down market year.

This then allows your investments time to recover while still meeting your spending needs. As such, cash value can serve as a good buffer asset, like cash or another non-market correlated asset, to support spending goals without locking in investment losses. By avoiding selling during down years, this can actually improve the longevity of a retirement investment portfolio.

3. **Pension Maximization Strategy**
Life insurance can also be used in retirement to offset the loss of a pension, annuity, or Social Security benefit that ends at the death of one spouse. With a single life pension payout or single life annuity, when the annuitant dies, payments stop. Life insurance can be purchased to provide the surviving spouse with the assets necessary to make up for this lost payment.

This is often called a pension maximization strategy as the life insurance essentially protects the pension or annuity payout for the surviving spouse. Tom Hegna, CLU, ChFC, CASL, LACP, economist, writer, and speaker, says that "I would recommend executing this strategy as early as possible since the younger you are, the lower the premiums of the life insurance policy will be. So, you can get the most leverage in protecting your future pension."

Additionally, a similar strategy can be undertaken with Social Security. If both spouses are eligible for and collecting Social Security, at least one of the two benefits will go away at the death of the first spouse. And so, you could protect against this loss of income by purchasing life insurance.

4. **Long-Term Care Planning**
Life insurance is a useful planning tool for funding long-term care expenses. First, many policies have an accelerated death benefit clause that can give you access to a reduced and early payment of the death benefit in certain situations. Often, when someone has qualified for long-term care services, the policy might be eligible to pay out at this time.

Second, life insurance policies can be purchased with a long-term care benefit rider on the policy, or existing policies can be 1035 exchanged for a policy with a long-term care rider. These riders can also be designed to provide a long-term care benefit.

While life insurance is often viewed as an insurance product designed for working years, it has many other uses. While this article looked at a few strategies there are many more.

As Mr. Hegna pointed out, life insurance can be used as a bond substitute that provides returns like a bond but without the downside of interest rate risk and at the same time provides tax diversification.

Ultimately, life insurance is a very secure and efficient way to protect income streams, create tax diversification with cash value, provide estate liquidity, transfer wealth, provide some long-term care financing benefits, and generate additional retirement planning flexibility. If you own life insurance, make sure you consider its potential value as a retirement planning asset.