Using life insurance for pension maximization

Marketing guide

Help your clients capitalize on their pension plans

North American Company for Life and Health Insurance
Since 1886

Life

Help your clients obtain financial protection and maximize their pension

Pension maximization using life insurance is a way to help your clients gain death benefit protection while offering an opportunity to maximize pension benefits. For public school employees, state and local government workers, and for those with companies that offer defined benefit pension plans, there is an important decision to make when it comes time to select the type of benefit they will receive. The choice generally is between two options: life only benefit or joint and survivor benefit.

The life only benefit provides the plan participant with the larger monthly benefit. This higher benefit payment, however, has a disadvantage: once the plan participant passes away, the benefit stops, leaving nothing for the surviving spouse. With the joint and survivor option, the participant receives a lower benefit and when the plan participant dies, the spouse continues to receive a pension benefit.

The joint and survivor option offers guaranteed income for the spouse, but if the spouse were to die prematurely, the plan participant is left with a reduced benefit for life. Additionally, pension plans generally don't provide heirs with a benefit when the plan participant dies. The pension maximization strategy provides a way to take the maximum monthly income provided by the life only option while still protecting the income for the spouse. In this guide you'll find information on the following:

A CLOSE LOOK AT PENSION MAXIMIZATION

Pension maximization is a strategy to gain death benefit protection and to help get the most out of defined pension plans. With this strategy, a life insurance policy is purchased on the life of the plan participant prior to retirement. It may be purchased closer to retirement, but because of age and possible health issues, purchasing the policy sooner may be in the client's best interests. The participant's spouse is named as the beneficiary of the life insurance policy.

The life insurance policy's death benefit would seek to match an amount that would replace the benefits for the surviving spouse as if the joint and survivor benefit option was selected. At retirement, the plan participant selects the life only benefit option in order to receive the larger benefit amount.

With the larger benefit, the participant may use a portion of the pension benefits to pay the life insurance premiums. The goal is to provide the spouse with the same benefit amount as if he or she elected the joint and survivor benefit option while the extra funds not used for insurance provides the plan participant with a larger, "max" pension benefit.

When the plan participant dies, the life insurance death benefit is paid to the spouse beneficiary generally income tax-free.[1] The death benefit can then be used to replace the lost pension income as a result of the plan participant's death. This can be accomplished through taking the death benefit proceeds as a life settlement option, using the death benefit proceeds to purchase an immediate annuity, or using other savings vehicles.

Using life insurance for pension maximization can be a strong strategy with teachers, government employees, and state and city workers. Consider the strategy for married individuals who participate in defined benefit pension plans and are comfortable using a portion of their pension benefit to fund a life insurance policy.

WHY LIFE INSURANCE FOR PENSION MAXIMIZATION?

Using life insurance for pension maximization has several advantages and a few items to consider.

Key advantages

- **Immediate death benefit protection.** Your clients gain death benefit protection.
- **Maximum pension income.** By selecting the life only option, the plan participant receives a larger benefit. Should the spouse die first, the participant isn't left with a reduced benefit should he or she have chosen the joint and survivor option. Under this scenario, the participant may also access his or her permanent life insurance policy's cash values through loans or withdrawals[2,3] to help supplement retirement income.
- **Death benefit for plan participant's spouse.** When the plan participant dies, the spousal beneficiary receives the life insurance policy's death benefit generally income tax-free,[1] which replaces the discontinued pension income.
- **Possible inheritance for heirs.** If the spouse predeceases the plan participant and the policy is kept in force until the plan participant's death, he could change the beneficiary designation to his heirs and then the policy's death benefit would pass to them.

Items to consider

- **Possible loss of spousal benefits.** With some pension plans, selecting the life only option may disqualify the plan participant's spouse from medical or other benefits that may be provided with the joint and survivor option. Be sure your clients consult with their benefit administrator to ensure they don't lose other valuable benefits without thorough contemplation of their worth versus the benefit of pension maximization.

- **Lapse of life insurance policy.** It is exceedingly important to keep the life insurance policy in force. Purchasing a guaranteed death benefit product may reduce the risk of lapse. There is no guarantee that the owner can pay the premiums, but a guaranteed death benefit product remains inforce when premium requirements are met.

- **Inadequate death benefit amount.** If the life insurance death benefit amount is inadequate, the spouse may not have enough to meet financial needs. Consider a highly conservative approach where the plan participant dies soon after retirement. Establish the death benefit amount on that scenario so that it can provide income for the life of the spousal beneficiary.

  If the plan is to allocate the death benefit proceeds to a saving vehicle to provide income for the spouse, the death benefit amount may be inadequate if the assumed interest earned on the death benefit is too high. Consider basing the rate of return very conservatively, similar to CDs or money market accounts.

- **Reducing the death benefit.** Consider reducing the death benefit of the life insurance policy as the amount needed to guarantee the income stream reduces. As the surviving spouse ages, it may take less death benefit to produce this income stream. Reducing the death benefit generally lowers the premium requirements, which can provide a larger pension maximization benefit. However, it's important to make sure that the client is aware of the planned decreases in the death benefit amount so that these changes can be made and the product performs as expected.

- **Cost of living adjustment.** Some pension plans offer a cost of living adjustment to keep pace with inflation. If this is the case, a larger death benefit amount or a slower schedule of death benefit reductions may be required for the strategy to remain viable.

- **Spouse may have little or no investment experience.** When the death benefit proceeds are paid, the spouse may not have the experience to help ensure the benefit will last, especially if it is paid in a lump sum. Consider a policy settlement option or an immediate annuity.

- **Impact of taxes.**[1] Consider taxes in matching the spousal income. Identify the after-tax benefit and try to match the after-tax benefit with the life insurance. The life insurance death benefit is generally income tax-free. This strategy can provide more accuracy and requires a lower death benefit, which in turn can lower premium costs and provide a larger pension maximization benefit.

HOW IT WORKS

Here are the steps to the pension maximization strategy using life insurance.

1. The plan participant purchases a life insurance policy. The death benefit is based on the amount that would replace the spouse's benefits paid under the joint and survivor option.

2. The plan participant chooses the life only benefit option at retirement rather than the joint and survivor option.

3. Upon death of the plan participant, the life insurance death benefit is paid to the spousal beneficiary. The pension benefits stop.

4. The life insurance death benefit proceeds are used to replace the discontinued pension benefit. This may be done through a policy settlement option, using the death benefit proceeds to purchase an immediate annuity, or allocation to a savings vehicle.

ILLUSTRATION SOFTWARE TIPS

The North American Company Illustration Software (NACIS) can help you put together competitive pension maximization cases. Here are a few tips to consider when working on your cases.

- **How to calculate the life insurance amount.** Find the surviving spouse benefit if a joint and survivor option was taken. That amount represents the target monthly income for the spouse. Next, identify the lump sum required to generate that monthly income. To do that, run a single premium immediate annuity (SPIA) with no period certain, or use an alternate savings vehicle, to find the amount needed to generate that target income for the spouse's life. The single premium amount represents the life insurance death benefit amount needed. As an alternative, the Insmark software, which is available via download from North American's website, also provides a pension module which can illustrate options other than SPIAs.

- **Decrease face amount.** The lower the cost of the insurance, the more money available for the retiree each month. One way to reduce the premium is to adjust the life insurance death benefit amount as needs change. Since the life insurance is being used to supply an income stream for the surviving spouse, as the spouse gets older, the funds needed may decrease. Search for the amount needed and adjust the death benefit amount at regular intervals (at least every 10 years). For example, search for the spouse's single premium life insurance need at ages 65, 70, 75, 80, 85, and 90.

- **What if the pension includes an inflation factor?** Some pension plans offer an increasing benefit to help keep up with inflation. For pension plans with an inflation factor, consider not reducing the death benefit amount as the surviving spouse grows older. By not reducing the death benefit, the proceeds may be large enough to generate a larger income stream when the insurance is needed. Solutions to generate the income stream may be adjusted to meet the spouse's needs at the time of death. That may involve an annuity with periodic withdrawals, a SPIA, or an alternate fund.

CLIENT PROFILE

For the pension maximization strategy using life insurance, the candidate must participate in a defined benefit pension plan. The employer funds the defined benefit pension plan with the goal of providing income each month during the participant's retirement. For this strategy, the participant is ideally within five years of retirement, which may lower premium costs since the life insurance is based on age, gender, and health. Here you'll find common traits for clients seeking a pension maximization strategy using life insurance.

- Ages 50 to 65
- Married
- Either spouse has a defined benefit pension plan
- Considering retirement
- Seeking to maximize monthly income
- Are prepared for the potential impact caused by loss of benefits for the surviving spouse that may be linked to the joint and survivor option

RESOURCES

Sales development

Phone: 800-800-3656 ext. 10411

Email: salessupport@nacolah.com

Hours: 7:30 a.m. – 5 p.m. CT Monday through Thursday
7:30 a.m. – 12:30 p.m. CT Friday

1 Neither North American Company for Life and Health Insurance nor its agents give tax advice. Please advise your customers to consult with and rely on a qualified legal or tax advisor before entering into or paying additional premiums with respect to such arrangements.

2 In some situations, loans and withdrawals may be subject to federal taxes. Clients should be instructed to consult with and rely on their own tax advisor or attorney for advice on their specific situation.

3 Income and growth on accumulated cash values is generally taxable only upon withdrawal. Adverse tax consequences may result if withdrawals exceed premiums paid into the policy. Withdrawals or surrenders made during a surrender charge period will be subject to surrender charges and may reduce the ultimate death benefit and cash value. Surrender charges vary by product, issue age, sex, underwriting class and policy year.

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