



**SELECT PORTFOLIO  
MANAGEMENT, INC.**  
Integrated Wealth Management  
A Registered Investment Advisor



White Paper:

*Using Cash Value Life Insurance for Retirement  
Savings*

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# Using Cash Value Life Insurance for Retirement Savings

## 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 your retirement. Cash value life insurance refers to a wide variety of insurance policies that provide both a death benefit and the 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 you make a series of premium payments and your beneficiaries collect the insurance amount if you die during the term of the policy. 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 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 and, in the case of a 401(k) plan, amounts contributed to the plan by an employee also 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in the cash value part of the policy due to investment or interest gains will be tax deferred until the money is withdrawn from the policy.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.

## When should you use cash value life insurance for retirement savings?

### To provide a death benefit to your family and to save for your retirement

You should use a cash value life insurance policy for your retirement savings if you would like to provide life insurance for your family, as well as save for your retirement in one combined insurance and investment vehicle. A cash value life insurance policy consists of two parts: a life insurance part and an investment part. Although you pay one premium for the total insurance policy, the premium you pay

each year is divided between the payment for the insurance and the payment for the investment savings.

## Life insurance

You should purchase a cash value policy if you have a need for life insurance. Whether you need life insurance involves several factors. First, do you have dependents (a spouse or children or even elderly parents) who rely on your income to maintain their standards of living? If you do, you should have life insurance to provide for your dependents in the event of your premature death. Second, even if you do not work (i.e., you are a "stay-at-home spouse"), do you provide services that your spouse would have to pay for if you were not around (such as 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?

### Life insurance protection for your family

One of the main strengths of using cash value life insurance for retirement savings is to provide life insurance protection to your family in the event of your premature death. If you save for your retirement by buying mutual funds or Treasury bills or by simply investing your money in a savings account at the bank, you will not have any life insurance. You would have to buy a separate insurance policy on your life. By buying a cash value life insurance policy, you can combine life insurance protection for your family with a savings vehicle for your retirement.

### 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.

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## 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.

## You can withdraw cash values

You may be able to withdraw some of the cash value from your life insurance policy (depending on the type of policy you have). The money can be withdrawn just like a withdrawal from a savings account at your bank. 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.

## You can borrow against cash value

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. 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?

### You must be insurable

You 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 whether you are insurable; the two most important are your age and your 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 your 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 a savings element. With a term policy, you are simply paying for a straight life insurance policy. 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).

## Amount of insurance you can purchase may be limited

The insurance company may limit the amount of insurance that you can purchase. If you want to purchase a very large insurance policy on your life, the insurance company may require you to justify the amount of insurance (i.e., prove why you need that much insurance). The insurance company may consider factors such as your income and the size of your assets. For example, if you earn \$50,000 per year, the insurance company may not be willing to issue a policy with a \$5 million death benefit on your 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. You should consult other resources for 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 during the first seven years, the policy is then permanently classified as a modified endowment contract (MEC) and is subject to special taxation rules. Under these special rules, policy loans are taxable, and withdrawals may be taxed (and even penalized). The rules concerning MECs are very complex. You should consult other resources before investing in a cash value life insurance policy.

## 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 your basis in the policy will be tax free (your basis is the amount of premiums you have paid into the policy net of any previous dividends and tax-free withdrawals). Any withdrawals in excess of your 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 you take out against the cash value of your life insurance is usually not deductible.

### Surrender of policy may result in taxable gain

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, let's say you pay \$5,000 per year in premiums for a \$300,000 cash value insurance policy on your life. Your only child is the named beneficiary on the policy. The payment of this \$5,000 premium is not a taxable gift from you to your child. However, if someone else pays the premiums for a policy that you own, then the payment of those premiums is usually considered to be a taxable gift to you. 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 you hold any incidents of ownership in an insurance policy or your estate is the beneficiary of the policy, the proceeds from that insurance policy will be included in your taxable estate. Furthermore, if you make a gift of an insurance policy on your life within three years of your death, then the proceeds from that policy will be pulled back into your 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.



## Disclosures

This material does not constitute the rendering of investment, legal, tax or insurance advice or services. It is intended for informational use only and is not a substitute for investment, legal, tax, and insurance advice.

State, national and international laws vary, as do individual circumstances; so always consult a qualified investment advisor, attorney, CPA, or insurance agent on all investment, legal, tax, or insurance matters.

The effectiveness of any of the strategies described will depend on your individual situation and on a number of other factors. After reviewing your personal situation, we may recommend that you not use any strategy in this document but instead consider various other strategies available through our practice.

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