Retirement

SURVIVOR SUPPLEMENTAL RETIREMENT INCOME FUNDED WITH LIFE INSURANCE

Presented for

Valued Client

Presented by

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The Purpose…

- Survivor supplemental retirement income funded with life insurance uses insurance proceeds to provide a supplemental spousal benefit that is higher than the "joint-and-survivor" benefits offered under the worker's employer-sponsored retirement plan.
- This allows the employee to choose the higher, single-life (life-only) annuity distribution option.

The Concept…

- The joint-and-survivor annuity option automatically provided by pension plans can greatly reduce the monthly benefit amount paid to retirees, since the benefit is designed to make payments over two lifetimes.
- By choosing survivor supplemental retirement income funded with life insurance, a retired worker receives the maximum monthly pension benefit amount—paid over the retired worker's lifetime only.
- This is a workable option because life insurance proceeds will provide the surviving spouse with an income source if the retiree is the first to die.

The Joint-and-Survivor Annuity Requirement…

- Current law requires most defined benefit and money purchase pension plans to provide a joint-and-survivor annuity option automatically.
- The required annuity must provide lifetime benefits for the retiree along with a survivor annuity for the lifetime of the spouse. The survivor benefit may not be less than 50% nor more than 100% of the retiree's benefit.
- To implement an arrangement other than the joint-and-survivor option, the spouse must waive the right to the plan's annuity survivorship benefits in writing.

The Need for an Alternative…

- A survivorship annuity offered under an employer's retirement plan can result in a substantial reduction in monthly retirement income.
- If the spouse dies first, no survivor benefit is paid, yet the retiree benefit has been permanently reduced.

- If a retiree remarries, no benefit is provided for the new spouse.
- With survivor supplemental retirement income funded with life insurance, however, the retiree receives the maximum monthly benefit for life without compromising income for a surviving spouse.

When This Alternative Is Not Advisable…

- The employee is close to retirement.
- The retiree is in poor health.
- The retirement plan provides an inflation-indexed payout.

The Reduced Joint-and-Survivor Benefit…

- The ages of the worker and spouse are important as they affect the amount by which the retiree benefit will be reduced if the retiree chooses the joint-and-survivor annuity.
- The table shows the cost of reduction over time when a retiree receives 75% of the otherwise available benefit. For example, a worker who would otherwise receive a maximum benefit of $1,500 monthly would lose $375 per month—a loss that totals $45,000 over 10 years and $90,000 over 20 years. This loss can never be made up, even if the spouse dies first.

Dollar Loss in Joint-and-Survivor Benefit (25% Reduction to Retiree)				
Monthly Life Income Option	**One Month**	**One Year**	**10 Years**	**20 Years**
$ 500	$125	$1,500	$15,000	$ 30,000
$1,000	$250	$3,000	$30,000	$ 60,000
$1,500	$375	$4,500	$45,000	$ 90,000
$2,000	$500	$6,000	$60,000	$120,000
$2,500	$625	$7,500	$75,000	$150,000
$3,000	$750	$9,000	$90,000	$180,000

- Obviously, the cost is high in terms of a substantial reduction in benefits to pay for a contingency that may or may not happen.

- Workers and their spouses must elect or waive the survivorship benefit within 90 days of the benefit start date. If they don't make an election, the survivorship election applies automatically.
- After benefits begin, the choice is irrevocable.
- In deciding whether to implement survivor supplemental retirement income, individuals must work with their tax advisors to determine the tax consequences.

How It Works…

- This arrangement involves purchasing a life insurance policy that will provide the surviving spouse with a benefit equal to the retiree's maximum pension benefit.
- The worker must be able to qualify for life insurance.
- The policy covers the life of the worker and names the spouse as beneficiary. The surviving spouse uses the proceeds to provide supplemental income if the worker dies first.
- The fund created with the policy proceeds should be equal to the pension benefit.
- If desired, just the earnings may be withdrawn from the capital account and paid to the surviving spouse instead of using a settlement option that provides lifetime income from the capital.
- After the insurance company issues a policy covering the worker's life, and with the spouse's written consent, the worker selects the life income option from the employer's retirement plan, which ensures that the full monthly benefit is available. These benefits end when the retiree dies, and the life insurance proceeds are paid to the surviving spouse.

Benefits of the Survivor Supplemental Retirement Income Alternative…

- Life insurance provides great flexibility.
- If the spouse dies first, the retiree can surrender the policy and use the surrender value to supplement retirement income. Alternately, the retiree can continue the policy and name another individual or a charity as beneficiary.
- During the retiree's lifetime, policy cash values accumulate on a tax-deferred basis.
- Should a retiree remarry, life insurance can provide benefits to a new spouse—an option that is not available with the joint-and-survivor annuity.

- The surviving spouse will have maximum control over the insurance proceeds, which can be used for a wide variety of income and planning needs.
- The surviving spouse can receive benefits as a tax-free lump sum or through any one of several settlement options.

Tax Considerations…

- If the retiree’s employer made all contributions to the pension plan, benefits paid to the retiree are fully taxable.
- If the beneficiary takes the insurance death benefits in a lump sum, they are not subject to income tax.
- Interest earned on proceeds held by the insurer under a settlement option is generally subject to income tax when received by the beneficiary.
- Death benefits that are paid over a period of time as an annuity are taxable only to the extent that the payment represents income. The portion that is considered to be a return of capital is not taxed.
- The taxable portion of an annuity payment is calculated by applying an exclusion ratio that reflects the amount that can be excluded from gross income annually.

The Best Prospects…

- Healthy workers in their 40s or 50s who are married, currently employed and covered by an employer pension plan.
- Any married worker concerned about providing lifetime income from a pension plan.

The Bottom Line…

Survivor supplemental retirement income funded with life insurance can provide the maximum retirement income to a retiree while ensuring that the surviving spouse will not suffer a loss of income after the retiree’s death. The retiree can use the additional income received under the life income option to pay for the cost of insurance, often with a significant surplus. If the spouse dies first, the retiree can withdraw policy cash values to enhance retirement income. Withdrawals and policy loans will affect cash values and death benefits, and may have tax consequences.

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SUMMARY

What Is Survivor Supplemental Retirement Income Funded with Life Insurance?

This is a strategy a worker can employ to provide a comfortable retirement income for a surviving spouse while maximizing the benefit amount the retiring worker receives for life from an employer pension plan. Instead of splitting the pension benefit with the spouse, the retiree retains the full monthly benefit available. The pension benefit will cease when the retiree dies. To protect the spouse if the retiree dies first, the retiree purchases a life insurance policy payable to the surviving spouse, which can be arranged to provide a monthly benefit.

Why Is This Alternative Desirable?

Under current law, most pension plans are required to automatically provide a joint-and-survivor annuity to married retirees, providing lifetime annuity benefits for both the retiree and a surviving spouse if the retiree dies first. The spouse's lifetime benefit must be no less than 50% and no more than 100% of the retiree's benefit.

The retiree's benefit will always be less with the spousal requirement than it would have been without, and this reduced benefit will not revert to the higher single-life amount if the spouse dies first. In other words, it's quite possible that the retiree will reduce his or her monthly benefit for life and the spouse will never use the spousal benefits.

With survivor supplemental retirement income funded with life insurance, however, there is no need to provide spousal benefits from the pension. Note: To implement this arrangement, the spouse must waive, in writing, the right to receive survivorship benefits. This typically must be accomplished within 90 days of the benefit start date.

How Does It Work?

The worker purchases a life insurance policy on his or her life providing a benefit equal to the worker's pension benefit, naming the spouse as beneficiary. The purpose of the policy is to pay proceeds that can become a capital account to pay the spouse a lifetime supplemental income if the retiree dies first. If the spouse prefers, the capital account can pay earnings only, keeping capital intact.

The worker selects a life income option, which provides the full monthly benefit when the worker retires. When the retiree dies, these payments end and the life insurance proceeds provide income to the surviving spouse.

Who Can Benefit from This Arrangement?

This arrangement is best suited for healthy people in their 40s or 50s, married, currently employed and covered by an employer pension. The plan can also benefit workers concerned about providing retirement income from a pension plan.

This plan is not suitable for workers very close to retirement, anyone in poor health, or workers whose pension plans provide an inflation-indexed payout.

What Are the Benefits of This Alternative?

Life insurance is flexible and can be used for different purposes if changing circumstances require. If the spouse dies first, the retiree can use loans and withdrawals to supplement retirement income.

Alternately, the retiree may continue the policy and change the beneficiary to another individual or a charity. This option is helpful if the retiree remarries, providing benefits for the second spouse that would not have been available with the joint-and-survivor annuity.

A spouse who receives policy benefits has complete control over how they are taken (either in a tax-free lump sum or in installments) and how they are used.

What Is the Tax Situation?

All employer contributions to the pension plan are fully taxable when paid to the retiree or the spouse. However, insurance proceeds paid in a lump sum are not taxable to the spouse (or other beneficiary). If the life insurance benefit is paid under a settlement option, only the interest is taxable to the beneficiary when paid. The portion that represents a return of capital is not taxed.

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