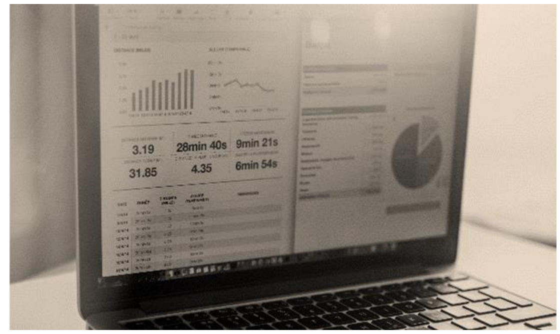
How Does Life Insurance Work In Your Cash Balance Retirement Plan?



Since 2006, cash balance retirement plans have become increasingly more popular with small businesses[1]. Cash balance plans offer many of the features that are attractive in a traditional defined benefit plan, while also including aspects that are similar to a profit-sharing plan. One of the reasons cash balance plans are so popular is that contributions are more predictable and level when compared to other defined benefit plans. Contribution amounts for targeted individuals can often be significantly greater than what is permissible in a profit-sharing plan.

Also, as opposed to traditional pension plans, participants receive statements that illustrate a hypothetical account balance in a current lump sum dollar amount rather than the traditional monthly benefit amount.

The target investment return for the plan is generally conservative, with annual rates of return typically between 4% and 5%[2]. As the portfolio is of a conservative nature, the underlining investments will also be on the conservative side. Typical investments may consist of CD's, money markets, bonds, mutual funds, and life insurance. Of the five investment options, many people are familiar with the first four types. People may not know that life insurance can be included as part of the investment mix in a retirement plan, including cash balance plans.

For most people life insurance is a necessity that must be bought. Many people see it as an expense. In a cash balance plan, however, it becomes a valuable asset that can cover numerous goals.

In properly administered plans, either a universal life policy with a fixed interest rate or a whole life policy can be used as a part of the investment line-up. Some whole life policies have a guaranteed cash value plus dividends (typically offered by mutual insurance companies) while other whole life policies have only a fixed interest rate (typically public traded insurance companies)[3]

Universal life policies generally have fixed interest attributed to their policies. There are differences between the two policies. To determine which one is right for you will depend on several variables that should be discussed with your advisor in the initial planning stages. Some of these variables include: amount of overall plan contribution sought after, liquidity flexibility, protection desired, and estimated time horizon for the length of the plan.

One of the main reasons why life insurance can make sense as an investment is that it builds cash value. The cash value of the insurance policy becomes part of the investment mix of the plan, just as any mutual fund or CD would. In today's low interest rate environment, the interest rates credited in these policies often make them very attractive investments when compared to money markets, treasury STRIPS (Separate Trading of Registered Interest and Principal of Securities) or CD's.

1: Gladych, Paula Aven Cash balance plans growing in popularity. Employee Benefit News November 26, 2017.
2: On October 19, 2010 the Internal Revenue Service (IRS) published final and proposed regulations for hybrid pension plans, which include cash balance and pension equity plans. These regulations provide guidance on changes made by the Pension Protection Act of 2006 (PPA) and the Worker, Retiree, and Employer Recovery Act of 2008 (WRERA). The final regulations generally adopt the transitional guidance provided in IRS Notice 2007-6 and in proposed regulations published in December 2007, with certain modifications. The proposed regulations address other issues most notably details on the market rate of return rules, that were not addressed in the final regulations. This is the latest release from the IRS.
3: Dividends may not be guaranteed.

All References to IRS Codes can be found at: https://www.irs.gov/privacy-disclosure/tax-code-regulations-and-official-guidance

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What's the Plan?

One of the most important aspects of a cash balance plan to remember is that the plan is building towards a lump sum benefit amount determined by IRS guidelines. For example, a participant who is age 52, makes the highest eligible salary ($330,000)[4] and has the highest allowable benefit will build to a lump sum of approximately $3,360,140[5] Regardless of the investments held in the plan, that one participant is only allowed to have a total amount of $3,360,140 as their benefit at retirement. If the underlying investments exceed the 4%-5% stated rate of return, annual contributions and any tax deductions associated with them may be reduced. As the plan gets nearer to completion, any amount over the $3,360,140 is generally taxed at an excise rate of up to 85%[6].

As life insurance has a generally fixed yield attributed to it, contributions can be constructed at a much more regular and consistent basis. At the completion of a plan, the participant has the right to the lump sum cash amount and any benefits of the plan. For plans with or without life insurance, the participant is entitled to the exact same dollar amount.

Additionally the very nature of life insurance brings the following benefits:

Family Protection: The fundamental benefit of life insurance is to create a large sum of money to protect your family. There is a need for most people to have life insurance to provide this benefit. Having a cash value insurance product may insure that the policy will be in force when you need it. The premiums are inclusive of the cash balance plan's contribution and are completely deductible[7].

Business Insurance: Another use for the life insurance can be business insurance. If there are partners or shareholders, insurance proceeds can allow for an orderly transition of the business while protecting a spouse.

With a specially designed beneficiary designation (with spousal approval), proceeds can be paid to a buy/sell trust. The trust then redeems the spouse's shares or partnership interest and receives the monetary proceeds.

Plan Self-Completion: The goal of the cash balance plan is to create a lump sum of money large enough to produce a lifetime stream of income.

However, if the participant dies in the first few years of the plan their beneficiary would only receive a benefit based on those contributions plus any interest. This would be significantly less than the ultimate amount that would have occurred at retirement. Having a life insurance policy as part of the plan ensures that the retirement lump sum goal is met.

4: Sections 401(a)(17), 404(1), 408(k)(3)(c).
5: Calculated based on the maximum annual benefit of $265,000 under Section 415(b)(1)(a) and section 115 of the Internal Revenue Code.
6: Section 4980(d)(1) of the Internal Revenue Code.
7: Cash balance plans may be reduced by fees & charges upon surrender.

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Estate Planning: As part of the clients overall financial planning, one of the goals may be to have asset liquidity upon death to pay any applicable estate taxes. Life insurance is a great tool to provide this liquidity. Depending on the circumstances, this process could hold several options. Once the cash balance plan is terminated the participant can roll the proceeds, which include the life insurance, into a profit-sharing plan.

The profit-sharing plan document must have IRS-approved language that permits life insurance as an investment. While rolling the insurance into the profit-sharing plan, the participant will also have to create an Irrevocable Life Insurance Trust (ILIT). Once the ILIT is established, the life insurance policy can be sold (as per IRS guidelines) to the ILIT. This will keep the death benefit income tax and estate tax free. This type of planning should be done with an experienced attorney whose expertise is estate planning along with a knowledgeable Financial Advisor.

For example: a participant age 52 with an insurance policy of $1,000,000 and cash value of $100,000 will have imputed income of $2,070 for the year[8]. This relatively small amount allows the insurance to remain income-tax free while in the plan.

Conclusion: Life insurance in a cash balance plan has many advantages: investment vehicle, plan completion, business succession, and estate planning are some of the most important uses. It certainly is worth reviewing with your design team to determine if life insurance in your cash balance plan is appropriate for you.

8: Internal Revenue Service Table 2001.

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