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The Year-End Relief Bill Revives A Retirement Income Planning Idea

Steve Parrish Contributor
Retirement
I write about retirement income planning – and risk.

With all the drama of the year-end relief bill, many missed the fact that it is part of a large budget law containing a number of tax changes. The Taxpayer Certainty and Disaster Tax Relief Act of 2020 (TCDTRA) is a component of the consolidated appropriations law, and it includes some long-awaited modifications and clarifications. One modification buried deep in the law essentially revives a retirement planning concept popular with some taxpayers. The core idea is that cash value life insurance can be used not only to provide an income tax-free death benefit at the insured's death, but it can also potentially be a source of tax-favored retirement income. If the insured builds up enough cash values during working years and is still alive at retirement, the values represent a pool of tax-deferred dollars available to supplement retirement. In a previous post, I explored how I used this technique to supplement my own retirement planning, and I'm encouraged that because of this law change, this retirement planning strategy will now be available for more Americans.

What Changed?

A challenge in this low interest rate environment has been that life insurance companies have concerns about offering these kinds of products. Tax law was making it difficult for these carriers because the government

required them to assume interest rates that are at a hypothetical guaranteed four percent. I'll spare you the details, but essentially in the TCDTRA, the law modifies Internal Revenue Code Section 7702 that defines what qualifies as life insurance. Under the new approach, insurers can use more realistic interest rates. Ray Bening, the past Chairman of FINSECA, a life insurance industry trade group, explains it this way, "To qualify as life insurance, the tax code required insurers to price premium maximums using an unrealistic return assumption; and in this extremely low interest rate environment, that caused insurance companies to worry about the risk they were taking on issuing these policies. With the new law, Congress modified the rule to allow insurers to use a floating interest rate, starting at two percent, giving them more flexibility in designing the maximum premiums on their products." Bening, a life insurance advisor who works with individual and corporate clients, sees this tax change as a needed fix. "It not only allows for some innovation in retirement planning, but also helps businesses with funding plans for their employees. It aligns the tax code with reality and gives both insurance companies and consumers some room to use premium levels that will last for the long-term."

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Uses In Retirement

M Financial Group, a major financial services design and distribution company, is pleased to have this change on the books. M Financial Group Vice President of Product Devin LaPlant sees this as "consumer friendly" in that it is aligning product pricing with consumer behavior. "The rate change allows consumers to sustainably fund their policies, resulting in more policy stability and less risk of lapse in a low interest rate environment, especially considering that during the pandemic, policy owners were understandably pulling their cash values. With this change in the definition of life insurance, there is room for more premium, and this offers a better reflection of real returns."

Eric Eklund, Senior Advanced Markets Consultant at M Financial Group, also points out that while IRC 7702 was originally written in 1984 to avoid abuses in stuffing life insurance contracts with *too much* tax-deferred cash value, a lot has changed in interest rates. He sees this modification to the rule as allowing companies to accept more premium in low interest rate environments while still avoiding abuse. "Now a policyowner can pay more premium to reflect that there's more at risk for the insurer."

There are both consumer and corporate retirement planning situations where life insurance is a useful tool. As before, individuals often purchase life insurance to provide a death benefit in the event of a premature death. The benefit generates liquidity to pay debts, cover taxes, or provide survivor income. As a source of added flexibility, however, individuals sometimes put enough money into their life insurance policies to create a cash value reserve which can potentially be tapped at retirement. It's just that now, the companies issuing these policies are in a better position to offer these kinds of contracts.

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Eklund points out that this offers more lifetime planning opportunities. For example, owners sometimes finance the cost of premiums using outside sources of capital. "Because this modification allows the insurance company to accept more premium, it makes premium-financed plans more stable." He also points to its application in corporate uses of life insurance. Split-dollar plans are a technique where an employer pays the premiums for a cash value life insurance policy that will be used as a "golden handcuff" to retain a key employee. With the ability to accept more premium in the policy, there is greater flexibility in designing such a plan. "With split-dollar plans, the idea is for the employer to eventually get its money back – and now there's more opportunity for this to work."

There are a variety of cash value life insurance plans available in the market, and this change in the tax law affects each of these products differently. Whole life insurance in particular was being threatened by unrealistic assumptions in IRC 7702. However, other cash value designs, such as universal life and variable life, had issues as well, further exacerbating the concern in that sometimes these policies offer other means of cash value access than just retirement. The policy may have a rider that offers long-term care or chronic illness benefits. With the ability to accept more premium, these benefits can become more stable for the long-term.

How would this work? Claudette wants life insurance, anticipating she will need it for a long time. Rather than just covering her pure death risk by buying term insurance, Claudette purchases a policy that will develop cash values. Her thinking is that if she dies before retirement, the added cost of the cash value policy (compared to term insurance) will be negligible; her family will still benefit from the tax-free death benefit. If, instead, Claudette

survives to retirement, she will have built up a reservoir of cash value that she can use to supplement her retirement income. The arcane changes to IRC 7702 mean nothing to her other than in this low interest rate environment, she will be able to put enough premium into her policy so that it will be more stable and more likely to provide the welcome cash value at retirement.

It may take some time this year for insurers to work through the details of this law change and how it translates to product design. One thing is clear: this welcome change offers another tool in the retirement tool kit.

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