PURCHASING LIFE INSURANCE WITH QUALIFIED FUNDS: WHAT YOU NEED TO KNOW

Written by Linas Sudzius, J.D.

Retirement money makes up a great deal of most people's savings. According to a 2022 report, total U.S. retirement assets have reached $37.5 trillion.[1]

The majority of retirement savings is made up of pre-tax money sitting inside of IRAs or in employer-sponsored retirement plans — such as defined benefit plans, Section 401(k) accounts or Section 403(b) accounts.

The federal government has created income tax incentives for taxpayers, and in some cases, their employers, to save money in such accounts. While contributions to such accounts may be tax-deductible and earnings are tax-deferred, distributions — when they are taken — are subject to income tax. Early distributions taken prior to age 59½ may also be subject to an extra 10% tax.

For the purpose of this guide, we will refer to pre-tax funds in employer-sponsored retirement plans or traditional IRAs as qualified plan money.

Traditional retirement planning for most consumers involves being encouraged to save as much money as possible on a pre-tax basis prior to retirement. Later, when retirement income is needed, they will take distributions from their qualified plan money — presumably paying income tax at a lower rate than during working years.

Many financial professionals encourage their clients to diversify their retirement assets from a tax perspective. Tax diversification means adding assets with different tax characteristics than qualified plan money to a person's overall retirement strategy.

Many consumers are being asked to consider taking a taxable distribution of qualified plan money to buy cash value life insurance. Some financial professionals argue that such a strategy is *never* a good idea, pointing out that investing in equities is always a better choice in the long run. Others argue that buying life insurance with qualified plan distributions should always be considered because of the many advantages that modern cash value policies offer.

Who is correct? There are many different factors involved in the decision-making process, including potential tax results and financial product features. Read on for our analysis.

BACKGROUND – FEDERAL INCOME TAX RULES

Qualified Plan Distributions

While qualified plan contributions are often said to be tax-advantaged, distributions from such plans are not.

DURING LIFETIME

In general, qualified plan balances grow tax-deferred.

When the owner of a qualified account takes distributions, there are usually two potential income tax results that need to be considered:

- Normal income taxes on the full amount of the distribution
- An extra 10% tax on the distribution if the taxpayer is younger than 59½

Income taxes are paid at the taxpayer's normal income tax rate.

The 10% extra tax usually applies when the taxpayer is younger than 59½, unless there are special circumstances. One special circumstance is when the taxpayer is disabled. Another way to avoid the extra tax, often recommended by tax professionals, is for the taxpayer to take so-called Section 72(t) distributions. Section 72(t) distributions are also sometimes referred to as substantially equal payments based on life expectancy (SEPL).

SEPL distributions are calculated in a precise way based on the life expectancy of the account owner.

[1] Investment Company Institute. June 15, 2022. "Retirement Assets Total $37.5 Trillion in First Quarter 2022." https://www.ici.org/statistical-report/ret_22_q1. Accessed Aug. 11, 2022.

The IRS issued Revenue Ruling 2002-62 addressing rules governing this exception to the 10% extra tax. The ruling sets out three acceptable methods for determining payments under a series of substantially equal periodic payments:

(1) the required minimum distribution (RMD) method,
(2) the fixed amortization method and
(3) the fixed annuitization method.

Once begun, Section 72(t) says the payments must generally continue unchanged for the longer of five years or until the taxpayer reaches age 59½.

AFTER DEATH

After the death of the original account owner, the value of the qualified plan passes to the beneficiary or beneficiaries of the account. The account continues to grow tax-deferred until distributions are made, at which point the beneficiary pays ordinary income tax on any distribution.

The additional 10% tax does not apply to distributions from an inherited qualified account.

MINIMUM DISTRIBUTIONS

The tax code does not permit qualified account owners or their beneficiaries to defer taxes on those monies indefinitely. There are rules regarding when distributions are required. These rules are often referred to as RMD rules.

For an overview of the RMD rules, the IRS has published an excellent FAQ at www.irs.gov/retirement-plans/retirement-plans-faqs-regarding-required-minimum-distributions.[2]

For the original account owner, RMDs must typically begin in the year the taxpayer turns 73. RMDs are calculated as a percentage of the account value — starting at about 4% for the first year — and the percentage goes up the older the account owner gets. The taxpayer pays income tax on distributions as they are received.

After the original account owner's death, the beneficiary or beneficiaries may have an annual RMD obligation and must generally liquidate the account by the end of the 10th year after the owner's death. Certain categories of beneficiaries may have different RMD timings. These special beneficiaries include:

- Surviving spouse
- Minor child of account owner
- Beneficiary no more than 10 years younger than account owner
- Disabled/chronically ill beneficiary

The beneficiary pays income taxes on the inherited qualified plan distributions as they are made.

Permanent Life Insurance

Life insurance's primary purpose is to provide a cash payout at the insured's death. That death benefit is generally income tax free.

While the premium paid for permanent life insurance policies is generally not income tax-deductible, cash value life insurance has certain other income tax advantages that can be helpful to policy owners.

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[2] IRS. March 16, 2022. "Retirement Plan and IRA Required Minimum Distributions FAQs." https://www.irs.gov/retirement-plans/retirement-plans-faqs-regarding-required-minimum-distributions. Accessed Aug. 11, 2022.

DURING LIFETIME

Life insurance policies' cash value grows tax-deferred, as does qualified plan money.

Tax-Deferred Buildup

The Treasury Department, the same organization that gives us the IRS, published an article on its website touting the tax-deferred cash value growth of life insurance:

Interest that remains inside a life insurance policy accumulates as long as the policy is in force. … The inside buildup is not subject to income tax if it is received as death benefits by the policy's beneficiary. Inside buildup is taxed if the policyholder surrenders the policy, but not if the policyholder merely borrows the inside buildup. [3]

Tax-Advantaged Access to Cash During Lifetime

Loans and withdrawals from a non-MEC (modified endowment contract) life insurance policy are often referred to as being income tax free.

Revenue Code Section 72(e) governs taxation of distributions from life policies. It says that withdrawals from a life policy are a recovery of basis first and taxable only after all basis has been recovered.

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[3] United States General Accounting Office. January 1990. "Tax Treatment of Life Insurance and Annuity Accrued Interest." https://www.gao.gov/assets/ggd-90-31.pdf. Accessed Aug. 11, 2022.

Loans

Code Section 72 says that for non-MEC life insurance policies, loans are not taxable distributions at all, as long as the policy stays in force. If the policy lapses or is surrendered, the entire loan balance at the time is considered a distribution, and it is taxed to the extent it exceeds the policy owner's premiums paid in the contract.

In addition, policy loans and withdrawals will reduce available cash values and death benefits and may cause the policy to lapse or affect any guarantees against lapse. Additional premium payments may be required to keep the policy in force.

Modified Endowment Contracts

Life insurance contracts that fail to meet the 7702A seven-pay test are MECs — but they are also still life insurance, because they meet the tests in Section 7702.

Section 72(e)(10) explains that MECs are taxed differently from "normal" life policies for the purpose of lifetime distributions. While MECs still get tax-deferred buildup during lifetime and tax-free death proceeds under Code Section 101(a), withdrawals are taxed gain-first. Distributions of gain are subject to income taxes, and if taken prior to age 59½, are also subject to a 10% penalty tax.

Loans taken against MEC policies are also treated as distributions for tax purposes, unlike those taken against non-MECs. Loan distributions are likewise taxed gain-first and are subject to the pre-59½ additional tax.

AFTER DEATH

Internal Revenue Code Section 101(a)(1) says that life insurance death proceeds are usually income tax free. There are some exceptions, but in most cases where the life insurance is purchased personally, those exceptions will not apply, and the death benefit will be paid to the beneficiary income tax free.

Distributions From Qualified Plans to Buy Permanent Life Insurance

If qualified plan distributions must be taken eventually, does it make sense for a taxpayer to reposition such distributions?

Many factors go into the decision to reposition assets, including return, risk diversification, tax diversification and the need for a death benefit. A discussion of risk diversification and return on investment is beyond the scope of this guide. However, a brief overview of tax diversification is helpful to understand more about the advantages of permanent life insurance.

TAX DIVERSIFICATION (THREE BUCKETS)

A simple way to visualize the impact of taxes on money is to divide assets into three buckets.

1. The Taxable Bucket represents accounts for which you typically receive a Form 1099 each year. Here are some examples:

- Interest from certificates of deposit (CDs)
- Dividends and taxable distributions from mutual funds held in nonqualified accounts
- Dividends and capital gains from stocks
- Interest and capital gains from bonds
- Reinvested dividends

2. The Tax-Deferred Bucket may include:

- Traditional IRA
- 401(k), 403(b), 457(b)
- Qualified and nonqualified annuities
- Appreciation of unsold mutual funds and securities
- Savings bonds

3. The Income-Tax-Free Bucket includes:

- Roth IRA
- Municipal bonds
- Appreciation of capital assets held until death
- Life insurance (if properly structured)

Roth IRA distributions are tax free if taken after age 59½, and the account has been open for at least five years. Municipal bonds are free from federal tax and may be free from state and local taxes.

Most financial professionals recommend diversifying retirement assets so that retirees can make sensible choices regarding how to position those assets to generate retirement income. Part of the diversification process includes tax diversification — placing some retirement assets in each of the available tax buckets.

MODERN PERMANENT LIFE INSURANCE POLICIES

At this point, it's helpful to have a very brief overview of permanent life insurance. In contrast to term insurance, permanent life insurance is designed to last for the insured's lifetime. Most permanent policies develop cash values that can be accessed during the insured's lifetime for the benefit of the policy owner.

In the past, most types of permanent life insurance policies were participating whole life. These types of policies had premiums guaranteed to stay level for the life of the policy. The policy also had cash values and death benefits that were guaranteed so long as the premiums were paid.

While participating whole life policies are still widely available, in more recent years, universal life insurance was introduced as another kind of permanent insurance. Universal life has more flexibility than participating whole life with regard to premium payments and policy changes. Universal life also has more built-in transparency than participating policies, making clear what the policy's guaranteed features and its current projected performance are based on.

Companies also developed permanent life insurance policies that allowed the policy owner some say about how their cash value earns interest. Variable life insurance lets the owner invest in a variety of investment options tied to the markets.

To address some of the restrictions associated with variable life insurance — risk of investment loss, often high internal costs and special licensing requirements — while keeping the investment control advantage, life insurance companies have developed indexed universal life insurance policies, also commonly known as fixed indexed universal life insurance. The indexed universal life policy can earn interest each year tied to an external index, such as the S&P 500, for example, without ever actually being invested in the index or the markets.

EXTRA FEATURES

Here's a list of modern life insurance policy riders and extra features that may be available in conjunction with the purchase of permanent life insurance that may influence the decision to use qualified money to buy such a policy.

ACCELERATED DEATH BENEFIT RIDERS

Accelerated death benefit riders, also called living benefit riders, are relatively new to the life insurance business. These types of riders pay out some or all of the policy's death benefit early, based on the insured's meeting the triggering event in the rider. The rider's triggering event might be:

- Terminal illness
- Major health event
- Chronic illness

Terminal Illness Rider

This kind of rider is normally added to life insurance policies at no additional cost. The benefit is paid to the policy owner when the insured is suffering from a terminal illness. The availability of the benefit is usually triggered by a doctor's certification that the insured has two years or less of life expectancy.

The amount of death benefit that may be accelerated under a terminal illness rider will vary by life insurance company and by policy. The company may also reserve the right to examine the insured when a claim is made to make its own assessment of life expectancy. The amount of the policy's death benefit that can be accelerated may be limited based on rider language or the policy owner's actual life expectancy at the time of claim. The amount paid under the rider usually directly reduces the amount that will be paid to a beneficiary at the insured's subsequent death.

The benefit paid under most terminal illness riders is income tax free to the policy owner.

Major Health Event Riders (Critical Illness Riders)

This kind of rider may cost extra or may be included at no cost. All kinds of health events may trigger rider benefits, depending on the rider language. For example, if the insured suffers a heart attack, the rider may say 25% of the death benefit may be accelerated to the policy owner.

These benefits are NOT a replacement for long-term care (LTC) insurance. Living benefits and LTC riders are not available on all life insurance products and may not be available in all states.

As with other accelerated death benefit riders, the amount accelerated reduces the benefit paid at death. Benefits paid under a major health event rider may be income tax free or income taxable, depending on how they are triggered and other circumstances.

Chronic Illness Riders

These riders are designed to pay a benefit when the insured is unable to take care of himself or herself due to chronic incapacity or mental impairment. Benefits are usually triggered under the rider in the same kind of circumstances as benefits are paid under a stand-alone, long-term care insurance policy.

The benefits are usually paid as a small percentage of the policy's death benefit for every year the insured is chronically ill. The accelerated benefit paid will typically reduce the death benefit dollar for dollar.

Benefits paid under a chronic illness rider are usually income tax free when paid to the insured, subject to certain limits established by the IRS.

Decision to Use Qualified Plan Distributions to Buy Life Insurance

So if you are considering using qualified plan distributions to buy life insurance, how would that work?

Mechanics and Tax Results

You would take distributions from the qualified plan, pay income tax on the distributions at the time they are taken (including any penalty tax if you are younger than 59½) and then use the after-tax money to pay the premium for the life insurance policy.

The key question for you to consider is this: Is it worth it to take a taxable distribution from a qualified plan in order to reposition the money into permanent life insurance?

The question has no abstract answer — each person's situation must be evaluated based on the situation and their objectives. Here are three sample fact situations that can help illustrate the point.

CASE STUDIES

Case Study One

Randy Bostian, age 49, is married to Tracy. They have three children. Randy has $200,000 in a traditional IRA, most of which came from a prior employer's 401(k) plan rollover. The Bostians have about $150,000 of additional net worth. Randy works as a corporate attorney, while Tracy manages the family full time.

Randy is considering using the money from the IRA to pay the premium for a permanent life insurance policy on his life.

Case Study Two

Gil Conner, age 68, is a retired widower with four adult children. Gil is collecting Social Security and a monthly pension benefit, and that income is adequate to cover his regular expenses.

Gil has about $900,000 of qualified money in various accounts, and he also has an after-tax capital asset investment portfolio worth about $1.5 million.

Gil is interested in maximizing the amounts that his children will inherit from him after his death.

Case Study Three

Dale Walker is 62 and married to Beth. They have two adult children. Dale is still working, and he plans to retire — collecting Social Security benefits and a defined benefit pension plan — at age 66. Dale and Beth feel that their retirement income from those sources will be just about adequate to provide for their future income needs.

The Walkers are interested in permanent life insurance to protect their legacy planning goals. In addition, Dale has $200,000 in an IRA account at their bank that is earning a very low interest rate. The Walkers are interested in repositioning at least some of that asset into something else that has the potential to grow their money more quickly.

These are hypothetical examples provided for illustrative purposes only; they do not represent a real-life scenario and should not be construed as advice designed to meet the particular needs of an individual's situation.

Appropriate Prospects

Based on the limited information in each of the case studies, if Randy, Gil or Dale are prospects for using qualified plan distributions to buy permanent life insurance, it seems that Dale's or Gil's situations are a better fit.

In Randy's case:

- At his age and wealth level, it is likely his financial focus would be on accumulating enough wealth to support retirement for himself and his wife. While cash value life insurance has certain tax advantages, it may not be in his best interest to incur an income tax result now to reposition his qualified money.
- Accessing the qualified money now will cost Randy the income tax hit, as well as a potential 10% extra tax due to the fact that he is younger than 59½. Although he may be able to avoid the extra liability by using Section 72(t) distributions, that path is inflexible and may cause him unexpected difficulties later on.
- While it may be smart for Randy to buy some insurance on his life to protect the family's income, term insurance may be a more cost-effective choice than permanent coverage.
- The Bostians' relatively long joint life expectancy generally makes potential capital asset returns, such as stocks or mutual funds, look more attractive.

In Gil's situation:

- Gil needs to think about what to do with his impending qualified plan RMD money, because it is not needed for current support. Using that money to buy permanent life insurance appears to be a reasonable choice for him to make.
- Gil's focus is probably not on cash value accumulation in the life insurance policy — his objective is to maximize his daughters' inheritance. That fact makes the income-tax-free death benefit of a life insurance policy look more attractive to him.
- At Gil's age, long-duration term insurance may not be available in the market, and term insurance prices may also be relatively unattractive compared to permanent insurance.
- Buying a permanent life policy with a chronic illness feature may be important to him to help protect against possible long-term care costs in the future.
- If Gil lives a long time, his daughters might get bigger inheritance if Gil had invested in capital assets. However, if Gil dies earlier than expected, the daughters' inheritance amount would be maximized through the proper use of permanent life insurance.
- Cash value may still potentially be available to Gil from the permanent life insurance to help protect against a catastrophic financial reversal.

In Dale's situation:

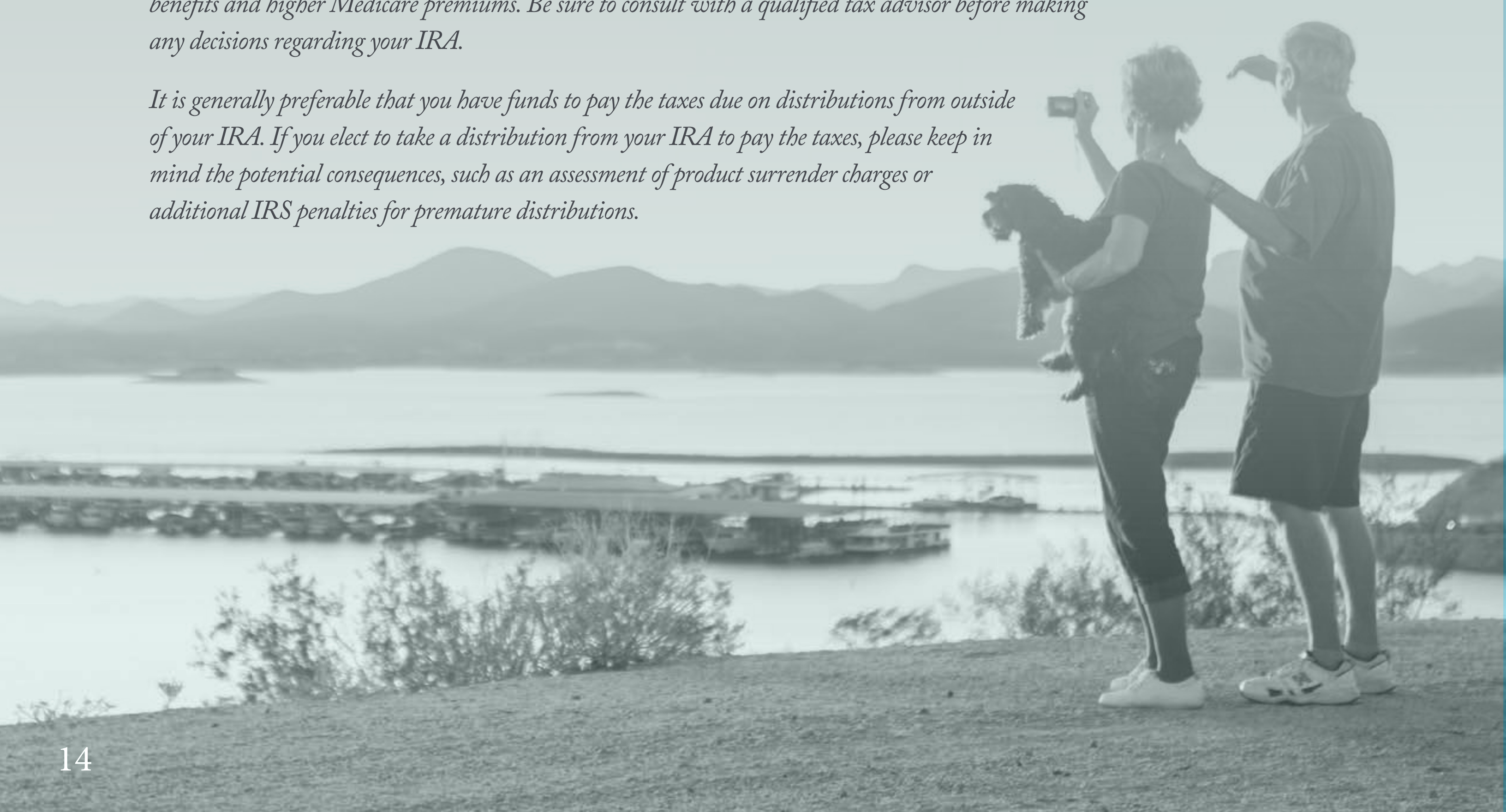
- Using IRA money to buy permanent life insurance is likely reasonable, as the IRA is not needed for the Walkers' support at any time in the near future.
- Buying a permanent life policy with a chronic illness feature on one or both of the Walkers' lives might be important to them to help protect against possible long-term care costs in the future — a possibility that might endanger their retirement income.
- The Walker children might get bigger inheritances if either or both the Walkers buy permanent life insurance.
- Life coverage might help protect and enhance a surviving spouse's retirement income.
- If money is needed in an emergency, any available cash value of permanent insurance can be accessed on a tax-favorable basis.

Case Study Summary

Balancing all factors relevant to the three situations, it seems less likely that Randy is a candidate to use qualified funds to buy permanent life insurance, while it's more likely that Gil and Dale may want to consider using their IRA funds to purchase cash value life insurance.

Please remember that repositioning qualified plan money to permanent life insurance is a taxable event. Increased taxable income from the conversion may have several consequences, including (but not limited to) a need for additional tax withholding or estimated tax payments, the loss of certain tax deductions and credits, higher taxes on Social Security benefits and higher Medicare premiums. Be sure to consult with a qualified tax advisor before making any decisions regarding your IRA.

It is generally preferable that you have funds to pay the taxes due on distributions from outside of your IRA. If you elect to take a distribution from your IRA to pay the taxes, please keep in mind the potential consequences, such as an assessment of product surrender charges or additional IRS penalties for premature distributions.



CONCLUSION

Are there any generalizations that can be made regarding the strategy we've considered in this guide? Here are a few:

- There may be circumstances where buying permanent life insurance with qualified plan distributions is a definite yes or no decision, but those cases would be rare.

- As with so many other financial decisions, the right strategy for any particular person depends on the relative importance of their specific financial goals.

- It's harder to imagine circumstances where a person younger than 59½ should use qualified plan distributions to buy permanent life insurance, because using such money to pay premiums is not tax-efficient, access to distributions may be inflexible and because there may be better choices for the long-term performance of retirement savings assets.

- It's important that the qualified plan distribution is sufficient to cover the required life insurance premiums. Otherwise, it will be necessary to take funds from another source to pay the premium due.

Those who are older than 59½ with substantial qualified plan balances are more likely candidates for using qualified plan distributions to pay for cash value insurance. They are particularly likely prospects if one or more of the following factors apply to their situations:

- They are at or near the time during which they must take significant minimum distributions.
- They have more money than they need to live on.
- They are interested in maximizing amounts passing to one or more heirs after death.
- They want heirs' financial gain at death locked in — no matter when death occurs.

Using qualified plan distributions to buy permanent life insurance is neither an inherently good or bad strategy. Carefully consider your retirement goals and take an objective and comprehensive look at your financial picture. Involve trusted professionals in the decision-making process and then decide if the purchase of permanent life insurance is right for you.

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