

How does Life Insurance work in your Cash Balance Retirement Plan?

Heritage Administrative Services LLC

Since 2006, cash balance retirement plans have become increasingly more popular with small businesses. 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.

As with all pension plans, plan trustees are responsible for the management of all assets in the plan. Many trustees choose to have an Investment Advisor or outside organization to take responsibility for creating their investment portfolio. The target investment



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

Life Insurance? That's right- life insurance. This article covers how life insurance can work in your cash balance retirement plan

For most people life insurance is a necessity that has to 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 publicly traded insurance companies). Universal life policies generally have a fixed-interest attributed to their policies. There are differences between the two policies and to determine with which one is right for you will depend on a number of 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 or CD's.

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What's the Plan?

The most important aspect of cash balance plans 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 50, makes the highest eligible salary (\$245,000) and has the highest allowable benefit will build to a lump sum of approximately \$2,400,000. Regardless of the investments held in the plan, that one participant is only allowed to have a total amount of \$2,400,000 as their benefit at retirement. If the underlying investments do fantastic in the market and greatly exceed the 4%-5% stated rate of return, annual contributions and any tax-deductions associated with them may be greatly reduced. As the plan gets nearer to completion, any amount over the \$2,400,000 is generally taxed at an excise rate of up to 85%. 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



How many eggs do you have in your basket?

amount and any benefits of the plan. For plans with or without life insurance, the participant is entitled to the exact same dollar amount. However, plans that include life insurance also allow the participant to keep the fully paid-up policy as an ancillary benefit of the plan in addition the lump sum cash 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 will 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.

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.

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 guarantee 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.

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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.

As there is a clear benefit to the participant by



How will you spend your retirement?

having life insurance in a cash balance plan, the IRS requires that some of the benefit should be 'inputted' to the participant as income. Depending on the age of the participant, the face amount of the insurance

policy and the cash value, an imputed income charge will be given to the participant at the end of the year on a 1099 form. This amount will be treated as taxable income to the participant.

For example: a participant age 50 with an insurance policy of \$1,000,000 and cash value of \$100,000 will have inputted income of \$711.00 for the year. 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.



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About Heritage Administrative Services LLC

Article written by Francis J. Mullady,
Member of Heritage Administrative Services
LLC. Should you have any questions
regarding this article, you may contact
Mr. Mullady by phone or email.

Phone: 631-423-0505

Fax: 631-423-9656

E-mail: FMullady@HGTPA.com

Heritage Administrative Services LLC is more than just a record-keeping firm. We provide a complete range of consulting, research, administration and communication services throughout the entire field of tax-qualified plans, non-qualified plans, investment analysis and estate planning.

At Heritage Administrative Services LLC, we recognize that your goal is to provide employee benefit plans which will be both understood and appreciated. Furthermore, we know that these benefits should be offered at a reasonable cost to your organization. Maintaining well-designed and administered employee benefit plans is an effective way to attract, retain and reward quality employees. They serve to position an organization for optimum growth, stability and profitability.

Contact An Office Near You

Main Office

135 Crossways Park Drive, Suite 402

Woodbury, NY 11797

Tel: (631) 423-0505

Fax: (631) 423-9656

Toll Free: (888) 863 6853

Branch Offices

New York, New York

Tampa, Florida

San Francisco, California

Dallas, Texas

Williamsburg, VA
