# How Life Insurance Plays a Tax-Advantaged Role in Supplementing Income in Retirement

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In the world of retirement income planning, the conventional wisdom regarding the need for life insurance during the retirement income planning period is to "buy term and invest the difference." This decision would be based on the idea that term life insurance offers lower premiums because it is temporary, and this allows more to be invested for retirement. This mindset assumes life insurance will not be needed after retirement, or after the kids have grown, and therefore investing offers the best opportunity for retirement success. Contrary to conventional wisdom, there can be an important role for permanent life insurance as part of the retirement income plan. Let's explore the possibilities of using variable universal life insurance and indexed universal life insurance as a tax-advantaged supplemental source of retirement income.

## What is universal life insurance?

Universal life insurance includes variable and indexed investment options. A key feature of these policies is that they provide permanent life insurance over the entirety of one's lifetime. These policies combine a death benefit with a cash value accumulation account. Deductions from the cash value are made to cover policy fees and the costs of providing the life insurance death benefit, and the remainder is invested as an asset for the policy holder. When structured properly, this cash value can be accessed in a tax-free manner either as a distribution of the policy's cost basis, or as loans from the policy for which the cash value serves as collateral.

Specifically, variable universal life insurance allows policyholders to invest the cash value into subaccounts with investment risk and growth potential through mixtures of stock and bond investments, similar to how any investment approach would work. Those who are familiar with investing for asset accumulation can apply that same approach when allocating within the life insurance policy. This creates volatility for cash value with greater upside growth potential but the possibility for losses.

For those seeking principal protection, variable universal life insurance may provide indexed accounts as investment options as well. Separately, indexed universal life is another option. The indexed approach provides principal protection for the cash value, with some exposure to gains from the corresponding market index. This can allow for participation in market recoveries without experiencing market declines. These indexed policies will include floors and caps or participation rates to supported credited interest payments, which helps to control volatility for the assets. Floors may alleviate the possibility of negative returns that can happen with variable policies, and these protections can be obtained by giving up some upside potential.

## Tax-efficient retirement planning

The value of permanent life insurance as a retirement planning tool relates to its ability to provide a tax-efficient source of supplemental retirement income. Federal and state governments provide different types of tax advantages to encourage various behaviors, such as planning for retirement or protecting loved ones with life insurance. The tax code provides advantages for savings in three possible ways:

1. One could receive a tax deduction for contributed funds, which reduces current taxable income.
2. Gains could accumulate on a tax-deferred basis.
3. The distribution of gains could be obtained free of additional taxes.

Aside from health savings accounts, it is rare to find a financial tool that offers all three of these advantages. A traditional IRA or a 401(k) retirement account does provide #1 and #2 as tax advantages, but all distributions from these accounts are then treated as taxable ordinary income. Deferred annuities provide the second advantage of tax deferral, but distributions will be taxed as ordinary income.

Meanwhile, there are three general tools that can provide tax advantages #2 and #3. These include Roth IRAs, municipal bonds (on a limited basis), and the cash value and death benefit of life insurance policies. Roth IRAs generally have low contribution limits and earned income limits for contributions. After exceeding these limits, permanent life insurance becomes the primary tool to obtain both tax-deferral and tax-free distributions for after-tax dollars. Deferring tax on investment gains will ensure a larger investment pool from which to draw distributions at a later date. In addition, those distributions may be taken tax-free.

Additionally, the risk of future tax increases is a real concern for many who are saving and planning for retirement, and life insurance can provide an important tool for managing tax risks by providing a source of spending that does not increase adjusted gross income and trigger taxes at a higher marginal tax rate. Higher tax rates in the future may be expected for reasons including: current high levels of government debt and borrowing; future strains to pay promised Social Security and Medicare benefits; the long-term impacts of government spending initiated in response to the global pandemic; and other fiscal and demographic issues. Also, retirees may find that their taxable income does not fall by as much as anticipated in retirement due to fewer deduction opportunities, the arrival of required minimum distributions on qualified retirement plans, and the impacts that taxable income has on generating further taxes on Social Security or increased income-related Medicare premiums.

For those worried about higher future taxes, there is value in planning ahead to include retirement income sources that will not be taxed. Roth IRAs have contribution limits, and one may wish to limit holdings of municipal bonds. This could leave life insurance — with practically unlimited contribution limits — as an important tool for obtaining additional tax-advantages for savings and wealth.

## A supplement source of retirement income

Including life insurance, versus only using investments, pits the tax deferral, tax-free distributions, and death benefit protections of the life insurance against the lower costs associated with the investment account that does not have to pay insurance costs and policy expenses. When using the cash value as a source for retirement income distributions, care must also be taken that the growth of the loan balance does not cause it to exceed the total cash value of the policy. If the purpose of the policy is to supplement retirement income, then life insurance is beneficial if its tax advantages exceed its insurance costs compared to holding assets in taxable accounts. This becomes an empirical question that I explored with Russell DeLibero in a 2017 article from the *Financial Services Review*. We found that even with today's current tax brackets, the life insurance strategy can be very competitive for assets otherwise held within a taxable account. Life insurance strategies would provide even greater benefits with an increase in future tax rates. In closing, we should be willing to challenge the conventional wisdom about the idea that investments alone provide the best approach for managing retirement income.

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