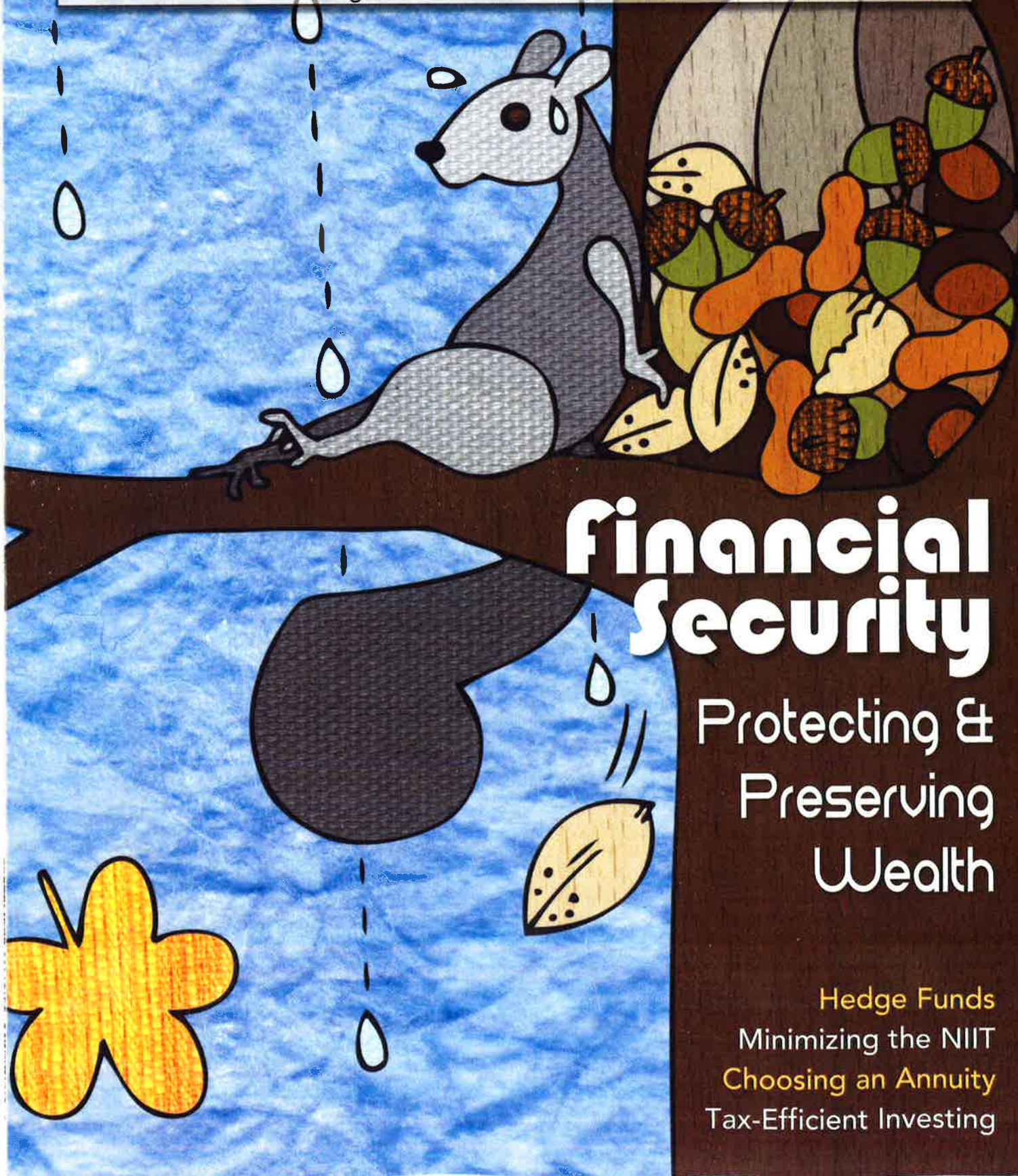


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Defined-Benefit Plans Can Meet Small Business Owners' Needs

By Matthew Gaglio

Thirty years ago, life insurance was a significant part of pension plan funding. It was not uncommon for insurance agencies to have dedicated pension specialists or even a fully staffed pension department. These pension specialists worked with the CPAs who, along with actuaries, were responsible for developing the strategy behind a plan and tailoring it to meet each small business' unique goals and objectives. Once implemented, the CPA remained actively involved, reviewing annual limits and laws in order to ensure that the tax benefits offered through the plan were fully realized by the business. To do that successfully, there was never any question whether life insurance would be part of the process; it was simply standard operating procedure to include a whole life insurance policy as an asset in a defined benefit plan within the "incidental benefit" limits prescribed by the IRS. Pension specialists and CPAs saw life insurance as integral in helping to protect and complete the benefits of a qualified retirement plan due to a premature death.

This way of thinking began to change with the Tax Reform Act of 1986, which eliminated much of the incentive for small businesses to provide pension plans. In the years that followed, companies largely adopted self-directed 401(k) plans, individual retirement accounts (IRA), profit-sharing plans, and other assets under management-type plans instead, all of which focused much more heavily on rate of return. Because large brokerage firms often managed these plans, CPAs and other financial planners gradually stepped out of the process.

Recently, however, certain changes to the tax code under the Pension Protection Act of 2006 (PPA) and the American Taxpayer Relief Act of 2012 (ATRA) have been made permanent, and traditional pension plans are making a comeback. CPAs have new



opportunities to help small business owners fully prepare for retirement with thoughtful pension plan design and strategic guidance. The challenge, of course, is that a full generation has passed since these advisors were heavily involved in the process and most are only familiar with self-directed defined-contribution plans that, like 401(k) plans and IRAs, focus only on rate of return. This emphasis on rate of return has only grown over the past five years as the stock market rebounded from the 2008 credit crisis.

As a result, many CPAs may not view life insurance as a valuable asset class for inclusion in a pension plan because of its relatively low rate of return. For the right person, a qualified defined-benefit plan that uses life insurance as a funding tool can be very effective in helping individuals reach their retirement goals.

Qualified Defined-Benefit Plans

A qualified defined-benefit plan is an employer-sponsored plan whereby business owners make contributions on behalf of

their employees. Upon retirement, former employees then receive a monthly payout, generally based upon their salary and length of service. Similarly, employers are also able to contribute to their own retirement plans. Typically the goal for small business owners is to contribute enough to fund the plan to the maximum monthly life annuity, equivalent to approximately \$2.6 million, which is the maximum lump sum benefit currently allowed by the IRS based upon a normal retirement age of 62 and the actuarial assumptions prescribed by the IRS. Annual contributions are generally based upon the age

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and compensation of the business owner at the time the plan is established.

For example, if a business owner is 47 when the defined benefit plan is established, the company may be able to contribute as much as \$173,333 annually to his plan to age 62, depending upon the applicable actuarial assumptions. This will change over the years, as assets within the plan continue to increase or decrease. When the \$2.6 million limit is reached (assuming it is increased by the IRS in the future), an employer generally may no longer make additional contributions to the plan for his benefit.

This makes a qualified defined-benefit

INSURED VERSUS UNINSURED PLANS

Purchasing an insurance policy outside a defined-benefit plan may not be as effective as within a plan. A whole life insurance policy in the amount needed to protect the total contribution will be costly when purchased outside the plan, because premiums are purchased with after-tax money. As a result, most will opt for term life insurance, which appears more affordable at the outset but whose premiums go up over time and at some point may become cost prohibitive. By that time, the insured is likely either to be elderly or has too many health issues to obtain affordable permanent life insurance.

Below is a comparison of an insured qualified defined benefit plan and an uninsured plan, illustrating the net distribution to heirs at age 65.

Retirement Plan Options

The following is a hypothetical comparison of an insured plan and uninsured plan, prepared for:

Unisex (Male) age 55 preferred nontobacco
39.6% income tax and 40% estate tax
5% investment fund growth
5% lost opportunity cost

	Insured Plan	Uninsured Plan
Annual Contribution	184,804	184,804
Funding Period	to Age 65	to Age 65
Investment Fund	1,244,927	2,440,725
Life Insurance Cash Value	929,619	0
Total Account Value Age 65	2,174,546	2,440,725
Total Death Benefit Age 65	4,548,885	2,440,725
Lost Opportunity Cost on \$2,826,369	0	218,271
Yearly Renewable Term		
Lost Opportunity Cost on Taxable Income	86,432	0
Estate Tax Age 65	(869,818)	(976,290)
Net to Heirs Age 65	3,679,067	1,464,435

Notes:

- Assumes no minimum required distributions.
- Assumes net death benefit paid outside of estate.
- Ongoing contributions will depend on investment experience and any declared dividends. Lump sum calculation must be within the prescribed limits as outlined by IRC section 417(e) and IRC section 415 (b) (per GATT).
- Income taxes do not take into account any income tax deduction for estate taxes paid, which a beneficiary may be able to deduct due to the inclusion of the qualified plan in the participant's estate.

plan a good choice for individuals who are late in starting the retirement planning process, as it provides for a defined retirement benefit and allows them to save a large sum of money in a relatively short period of time. Like many plans, the contributions are tax deductible, within limits prescribed by the IRS, and grow on a tax-deferred basis until withdrawal. In addition, a qualified defined benefit plan may provide the business with an important tax advan-

includible for estate tax purposes, the proceeds can also help protect the assets in the plan by providing enough cash after death to pay estate taxes. In this case, a minimum policy of \$3 million is recommended to cover the full \$2.6 million retirement benefit, but far more can be purchased.

It is important to note that the beneficiary is not taxed on any proceeds from the death benefit that are over and above the cash value of the whole life insurance

those in today's top tax bracket, pension contributions can prove a better rate of return than the underlying investment.

Because life insurance has a slower rate of growth, typically around 3%, it can extend the number of years an employer is able to make tax-deductible contributions to the plan. The real value of using life insurance as an asset class, however, is the protection. Because the death benefit, within the incidental benefit rules, is recommended to be as much as (if not more than) the full \$2.6 million allowed in the plan, it offers full protection to a small business owner's heirs.

This makes a qualified defined-benefit plan a good choice for individuals who are late in starting the retirement planning process, as it provides for a defined benefit and allows them to save a large sum of money in a short period of time.

tage, because eligible contributions are considered reasonable business expenses.

Any discussion of using life insurance in a qualified retirement plan must also consider a strategy for removing the life insurance from the plan upon reaching normal retirement age or separating from service. This topic is beyond the scope of this article.

Funding Qualified Defined-Benefit Plans

Funds contributed to the pension plan are typically either placed into equity investments or split between equity and fixed-income options. Including a whole life insurance policy in the plan may be a sound strategy for a individual business owner looking for life insurance protection.

Under this type of design, life insurance premiums are paid to a pension trust covered under IRC section 401(a), with tax-deductible contributions into the plan. This means that a small business owner can afford the amount of insurance needed to meet a number of objectives. It provides a death benefit, which can self-complete the plan should the insured die before reaching retirement age. Although

policy. As a result, excess funds can be used to cover potential planning needs, such as distribution, key personnel, succession, business continuation, or legacy planning strategies.

Many CPAs might argue against the value of using life insurance as an asset in such a plan. The common objection is that the rate of return on a whole life insurance policy drags down the performance of the overall portfolio. While that's true, it is not necessarily a bad thing where defined-benefit plans are concerned, because slowing the rate of return can actually save on taxes in the long term and stabilize market volatility in the short term.

The goal behind establishing a qualified defined-benefit plan for a small business owner is to provide a benefit that is guaranteed and reap the tax benefits for as long as possible. The higher the rate of return in the plan, the faster it will be funded. This means that if the stock market is doing particularly well, what might have taken ten years to fund takes only six—leaving the small business owner without the intended tax benefits through plan contributions for the remaining four years. For

Meeting the Needs of Small Business Owners

Priorities change as people age. What's important to individuals in their 30s and 40s shifts as they approach their 60s and 70s. When a business owner is in his or her 30s or 40s, the idea of a high rate of return is attractive. They often assume they will amass enough wealth over time to cover any potential estate taxes, and that the need or associated cost of life insurance is not necessary. Of course, this is rarely the case. By the time they have reached their 60s and 70s, many business owners recognize that life insurance and wealth protection are necessary. That's because they realize they want all of the money they've earned to go to their heirs and not to estate taxes.

Wealth accumulation regardless of market sectors (stocks, bonds, mutual funds) is always attractive. Nevertheless, at some point, allocating preservation dollars and factoring that into the equation for rate of return can deliver a better overall result to the insured and beneficiaries. By recommending that small business owners purchase a whole life insurance policy in a qualified defined-benefit plan, CPAs are able to foresee and ultimately meet their changing needs. This strategy efficiently provides a tax arbitrage for the short term, and effectively protects wealth in the long term, ensuring as much of the estate as possible is preserved and passed on. □

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