LIFE INSURANCE

Section 4

Retirement and Other Insurance Concepts

Third-party ownership

There may be up to three parties involved in a life insurance policy, the owner, the insured, and the insurer.

Key person life insurance and partnership life are both examples of third-party policy ownership. Buying insurance on the life of a spouse or minor child is also an example of third-party ownership.

When a third party owns the policy, the insured has no owner's rights, these rights belong to the third party. It is the owner of the life insurance policy, not the insured, that has the right to select or change the beneficiary, pre-select the settlement options, choose the dividend option, and assign the benefits of the policy.

Three parties sign a life insurance application, the owner, the insured, and the producer. The producer is not a party to the contract, but they are the front-line underwriter.

Beneficiaries never sign anything.

Life Settlements

Both stranger-owned (originated or oriented) life insurance (STOLI) and life settlements involve transferring a life insurance policy to a third party. However, while STOLIs can be illegal and used in fraudulent schemes, a life settlement is a legal and regulated option for policyholders.

There are two types of settlements available: a life settlement or a viatical settlement.

A life settlement is an arrangement in which a policyholder sells their life insurance policy to a life settlement company or broker. The payment they receive will be lower than the death benefit. Life settlement companies and brokers must be licensed and regulated by states' insurance departments. Variable life settlements are securities transactions that are subject to federal securities laws and applicable FINRA rules. The purchasers of life settlements, sometimes called life settlement companies or life settlement providers, generally are institutions that either hold the policies to maturity or resell policies—or sell interests in multiple, bundled policies—to hedge funds or other investors.

A viatical settlement is an arrangement similar to a life settlement, but the individual insured under the life insurance policy must be chronically or terminally ill.

Policyholders also have the option to surrender their life insurance policies in exchange for their cash value minus applicable fees – called the cash surrender value. However, this option may pay less than a life or viatical settlement.

Group life insurance

Group life ratings and forms do not have to be filed with the Insurance Commissioner. Group life is usually term insurance. Group life usually has low to no underwriting. Employees covered by group life receive certificates of insurance, not individual policies. Experience rating is used for large groups only. Rates are based on claims experience. Individual life insurance policy premiums are usually more expensive than group life insurance premiums. A group cannot be formed for the sole purpose of buying life insurance.

Conversion privilege
When a person covered under a group life policy terminates employment they have the right to convert to an individual whole life policy, regardless of health, for 31 days. The premium on the converted policy will be based on the employee's attained (current) age.

Contributory vs. noncontributory
In group life, the insurer requires a certain percentage of those eligible to enroll to prevent adverse selection. Adverse selection occurs when only the bad risks sign up for insurance.

In a contributory group life plan the employee pays part of the premium. The participation percentage for a contributory life policy is 75%. 75% of the eligible employees must participate.

In a noncontributory plan, the employee does not pay any of the premium, the employer pays 100% of the premium. In a noncontributory group, the participation percentage is 100%. 100% of eligible employees must be enrolled.

Retirement plans

Qualified
Qualified retirement plans must follow ERISA (Employee Retirement Income Security Act of 1974). ERISA sets forth guidelines including nondiscrimination, funding, eligibility, vesting, and disclosures.

Traditional IRAs

Contributions and deductible amounts
An individual of any age with earned income can contribute to an IRA. There is a maximum annual contribution limit to an IRA, subject to change by the IRS. There is no minimum contribution limit to an IRA. IRA contributions may or may not be tax deductible. If an individual is an active participant in another qualified plan in order for the contribution to be tax deductible their income must be below a certain level (varies by year). A minor cannot establish an IRA unless they have earned income.

IRAs may invest in stocks, bonds, mutual funds, ETFs, certain gold and silver coins, and annuities. An IRA may not invest in life insurance or collectibles.

Traditional IRAs must follow the required minimum distribution rule (RMD).

Contributions into an IRA must be made by that year's income tax due date (generally April 15th). Catch-up contributions may be made by those persons 50 years of age or older.

Premature distributions (including taxation issues)
Premature distributions (under age 59 ½) from a traditional IRA are subject to a 10% early withdrawal penalty. There are some exceptions to this penalty. The following are exceptions:
- $10,000 towards first-time homebuyer expenses
- Qualified educational expenses
- Death
- Disability
- Annuitization

Annuity phase benefit payments
An individual may choose to roll over their IRA balance into an immediate annuity. If the traditional IRA was funded entirely by tax deductible contributions, the annuity funded is a qualified annuity with a zero cost basis. In this case, 100% of the monthly payment amount will be taxable as ordinary income. Using the IRA to fund an annuity ensures that the individual receives a dollar amount monthly for life, alleviating any concerns related to outliving the account balance.

Values included in the annuitant's estate
The value of an annuity or other payment received by any beneficiary because of surviving the decedent is generally included in the decedent's gross estate. If the beneficiary does not receive any monies then there is no amount to include in the decedent's gross estate.

Amounts received by beneficiary
The annuity may or may not have a beneficiary during the payout period, depending on the option selected by the annuitant. If there is a beneficiary and the annuity is qualified the amount received by the beneficiary is taxable to the beneficiary as ordinary income. If the annuity has been funded with after-tax dollars then only the earnings distributed to the beneficiary would be taxable to the beneficiary as ordinary income.

Roth IRAs

Contributions and limits

Contributions made into a Roth IRA are always in after-tax dollars. The Roth IRA has the same annual maximum contribution limit as the traditional IRA. Anyone of any age, with earned income, can fund an IRA, up to the limit, or earned income that year, whichever is less. However, unlike a traditional IRA, the Roth IRA does have upper-income limitations that vary by year, as set by the IRS. If an individual makes more than the threshold that year then they cannot fund a Roth IRA for that year.

Earnings in a Roth IRA are tax-free when it is a qualified distribution. If the account has been open for a minimum of five years and the earnings are paid out on or after age 59 ½ it is a qualified distribution. The money contributed to a Roth IRA may be taken out at any time, without penalty since it is after-tax dollars. Withdrawals are FIFO, first in, first out (contributions come out first). If a distribution of earnings is made under age 59 ½ there is a 10% early withdrawal penalty, with the same exceptions as the traditional IRA.

Distributions

Roth IRAs are not subject to the required minimum distribution rules. Distributions from a Roth IRA are tax-free.

Types of qualified plans

Simplified Employee Pensions (SEP-IRAs)

A SEP-IRA is a tax-qualified plan for self-employed persons and small businesses.

SIMPLE plan

A SIMPLE plan is also a tax-qualified plan for employees of a small business.

Keogh (HR-10)

Keogh plans are available to self-employed sole proprietors, partners, and their employees. They are not available to corporate officers. Keogh plans are also known as HR-10s. Self-employed people can also fund a solo 401(k).

TSA

A TSA is a tax-sheltered annuity. It is an annuity funded with pre-tax dollars. TSAs are available to public school employees and nonprofits. They are also called 403b plans.

401(k)

A 401(k) is a qualified plan for large employers.

Profit-sharing plans

Any size business can set up a profit-sharing plan. The business can also have other retirement plans. A profit-sharing plan accepts discretionary employer contributions. There is no set amount that the law requires the business to contribute. The business can contribute in some years, on not in others. When the business does make contributions there must be a set formula for determining how the contributions are divided. This money goes into a separate account for each employee. A profit-sharing plan can be simple or complex. Profit-sharing plans must file a Form 5500 annually.

Contributions
Qualified plans have annual contribution limits set by the IRS. Catch-up contributions may be made by those persons 50 years of age or older.

Distributions

Premature
Premature distributions (under age 59 ½) from a qualified plan are subject to a 10% early withdrawal penalty. There are some exceptions to this penalty. The following are exceptions:

- $10,000 towards first-time homebuyer expenses
- Qualified educational expenses
- Death
- Disability
- Annuitization

The 10% early withdrawal penalty is in addition to any income taxes due. Qualified plans are funded with pre-tax dollars. Distributions from qualified plans are taxable as ordinary income.

Requirement minimum distributions
Most qualified plans are subject to the IRS required minimum distribution rule. Tax-qualified annuities and traditional IRAs are also subject to this rule. Beginning in 2023, persons aged 73 or older are required to take minimum distributions from their qualified plans. If they do not take out at minimum the minimum distribution there is a 25% penalty. This penalty will be lowered to 10% if the missing RMD is timely corrected within two years. In 2033, the age RMDs must begin increases to 75.

Nonqualified plans
Nonqualified plans do not follow ERISA.

Deferred Compensation
Deferred compensation is a non-qualified plan. It is discriminatory and set up in favor of higher-paid workers. The employer does not fund a non-qualified plan. If the employer should go broke the employee will not get paid.

Rollovers and transfers (IRAs and qualified plans)
There are two main types of rollovers – direct and indirect. In an indirect rollover, the money is paid to the individual. When the money is paid to the individual there are 60 days to put it into a rollover IRA, otherwise, the IRS will tax the distribution as ordinary income, and depending upon the person's age there may also be an early withdrawal penalty. Only one indirect rollover is allowed in any 365 days. When a retirement plan distribution is paid to the participant it is subject to mandatory income tax withholding of 20%, even if those distributions may later be rolled over to another plan.

In a direct rollover, the funds are paid directly to the custodian instead of to the individual. There is no limit related to these types of direct transfers. A direct rollover is the safest way to move money from one retirement account to another. Trustee-to-trustee rollovers (direct rollovers) eliminate the withholding tax requirement.

A distribution from a qualified plan may be rolled over into an IRA, without a dollar limit.

Section 1035 exchanges
Section 1035 of the Internal Revenue Code allows cash surrender on a tax-deferred basis when moving cash between certain insurance products.

The following are all allowed under Section 1035, moving cash from:

- An “old” annuity into a “new” annuity
- An “old” life insurance into “new” life insurance, and
- An “old” life insurance into a “new” annuity

Section 1035 does not allow the insured to better his or her tax position. If the insured takes cash surrender out of an annuity and funds an IRA or life insurance, the cash surrender is treated as a taxable event.

The owner and insured, or annuitant, on the "new" contract must be the same as under the "old" contract.

Life insurance needs analysis/suitability

Personal insurance needs
There are two different methods of determining how much life insurance coverage a person needs – human life value and capital needs.

The human life value approach looks at how much income the person is expected to generate over their life and determines a face value based on that amount.

The capital needs approach looks at how much money would be needed if the insured should die tomorrow. Needs include money to pay off the house, put the kids through school, and allow the spouse to take some time off from work. The face amount is determined by these needs.

Business insurance needs

Key person
A business usually purchases key person life insurance on a company executive. The key person life insurance policy is owned by the business. It is an example of third-party ownership. Key person life insurance would pay the face amount to the business if the key person dies.

Premiums paid for key person life insurance are not tax deductible to the business since it is a policy that benefits the business. Life insurance proceeds are not taxable.

Buy sell
Stockholders in closed corporations (small privately held) often enter into buy-sell agreements with the corporation that are funded by life policies.

Premiums paid for partnership life insurance are not tax deductible to the business since it is a policy that benefits the business. Life insurance proceeds are not taxable. The life insurance proceeds are used to buy out the heirs of the deceased stockholder (business partner).

Executive bonuses
Executive bonus life insurance is a type of group life insurance product offered to individuals in C-suite positions, such as chief executives, operations executives, or chief financial officers. Executive bonus life insurance enables a business to provide life insurance to a given key employee or high-performance employees in a tax-advantaged way. The premium paid by the business for executive bonus life insurance is tax deductible so long as the bonus is considered reasonable compensation. The policy is owned by the executive. The key employee names the beneficiary and can access the policy's cash value.

Social security benefits

Social Security provides financial protection, supporting Americans throughout all of life's journeys. Social security includes various benefits including retirement, disability, survivor, and family benefits, as well as Medicare. Sometimes you will see Social Security referred to as OASDHI (old age, survivor, disability, and health insurance).

Note that Social Security does not include Medicaid. Medicaid is medical welfare and is based on financial need. Social Security includes Medicare Parts A, B, C, and D.

Social Security has a very small ($255) death benefit. This amount is the same for everyone.

Social Security retirement, disability, and survivor benefit amounts are based upon a person's PIA (primary insurance amount). This is why it is so important that people check their Social Security records.

The age at which an individual reaches full retirement age varies by birth year. To be fully eligible for Social Security benefits one must be fully insured which means they have contributed to Social Security for a minimum of 40 quarters (10 years). When an individual delays taking their Social Security retirement benefit their monthly benefit amount increases an additional 8% a year, from their full retirement age until age 70. Full retirement age currently is between age 65 and 67 depending on birth year.

When there is inflation in the economy Social Security benefits will increase. Social Security is indexed for inflation (tied to the Consumer Price Index - CPI).

The Social Security disability income (SSDI) program pays an individual and certain family members if the individual meets the definition of fully insured. The Supplement Security Income (SSI) program pays benefits to adults and children who meet the requirements for a qualifying disability and have limited income and resources. These two programs are different, but the medical requirement is the same. The medical requirement is that the condition must be expected to last at least one year or result in death.

Tax treatment of insurance premiums, proceeds, and dividends

Premiums paid

Individual life

Individual life insurance premiums are not tax deductible.

Group life

Group life insurance premiums paid by an employer are tax deductible as a business expense to the employer.

When the premium is paid by an employer for a group life term insurance policy with a death benefit of less than $50,000 the premium paid is not taxable to the employee as income.

Any premium paid by an employer for coverage over $50,000 is taxable to an employee as income.

Amounts available to the policyowner

Cash value increases

As the cash value increases over time, the earnings are not taxable to the policyowner.

Dividends

Mutual insurers issue participating policies. Participating policies may pay dividends to the policyholders. These dividend payments are viewed as a return of premium and are not taxable.

When the owner of a participating policy chooses the dividend option of interest the interest paid is taxable as ordinary income.

Policy loans

Policy loans on cash value policies are not taxable.

Surrenders

When taking cash surrender any amounts received in excess of premiums paid are taxable as ordinary income.

Amounts received by the beneficiary

General rule and exceptions

Generally, most life insurance proceeds are not considered taxable income. However, there are exceptions. If the death benefit is paid in installments, the interest accrued is taxable. If the policyholder names an estate as the beneficiary, the estate may be subject to estate taxes.

Settlement options

Unpaid death benefits continue to earn interest for the beneficiary. The interest is taxable as ordinary income. When a beneficiary elects the annuity option and outlives the face amount, those payments are taxable as ordinary income.

Values included in the insured's estate

When the owner and the insured are the same party the life insurance face amount is included in the decedent's estate. When the owner is someone other than the insured then the face amount is excluded from the decedent's estate.

Modified Endowment Contracts (MECs)

Modified endowment versus life insurance

Life insurance is protection. As a general rule, a cash value policy does not have cash value for the first three years.

A modified endowment contract (MEC) is created when the cash value grows too quickly in the beginning years of the policy. A MEC is a life insurance policy that has lost its tax benefits. When too much in premiums is paid into a life insurance policy in too short of time the IRS will relabel the policy as a MEC.

Seven-pay test

There is a seven-pay test to determine if a life insurance policy is a MEC. If the cash value exceeds the premiums paid during the first seven years it becomes a MEC. Once a life insurance policy fails the seven-pay test it becomes a MEC for the life of the contract.

Distributions

When a life insurance policy is classified as a MEC its tax treatment changes. Withdrawals from MEC are treated the same as a withdrawal made from a non-qualified annuity. Premiums are paid in after-tax dollars. Any withdrawals (including loans and partial surrenders) taken from cash value accumulation are taxed LIFO (last in, first out - earnings come out first). Earnings are taxable as ordinary income. Additionally, MECs have a 10% penalty for distributions made under age 59 1/2 (premature distributions).