



Pension Maximization: A Strategy Using Life Insurance

Producer Guide

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Pension Maximization is a life insurance strategy that has been used for many years. It is used most effectively for married individuals who are currently participants in a defined benefit pension plan, are 10-15 years away from retirement and who are comfortable allocating some of their retirement income to pay premiums on life insurance. There are not as many defined benefit qualified pension plans as there used to be, as many employers have moved to defined contribution plans, such as 401(k)s. However, there are still many plan participants who will soon be eligible to receive benefits from old defined benefit plans that the employer may no longer be maintaining for newer employees. Thus, there is still considerable market potential for this strategy, especially in the over age 50 market. Plan participants who will soon be retiring

typically have to make an election prior to retiring regarding what type of benefit they will receive. Their choices generally come down to electing a Life Only benefit for the life of the plan participant or some sort of Joint and Survivor benefit that pays a benefit for as long as the plan participant and his/her spouse live.

As you might suspect, the Life Only benefit is generally larger, often times one-third or more than the Joint and Survivor benefit. Thus, the plan participant is generally making an election involving (1) a larger lifetime benefit with no survivor benefit (Life Only) versus (2) a reduced lifetime benefit but a continuing income for the surviving spouse (Joint and Survivor). The chart below helps to illustrate some of the available choices.

Hypothetical Comparison of Life Only vs. Joint and Survivor

| Option | During Participant's Life | At Participant's Death, Spouse Receives | Cost to Participant in Lost Pension Benefits |
|--|---------------------------------|---|--|
| Life Only Option Participant receives maximum lifetime benefit/spouse receives nothing after participant's death | \$2,000/month before income tax | \$0/month before income tax | Monthly - \$0 Annually - \$0 Over 10 years - \$0 (all before tax) |
| Joint and 50% Survivor Option Participant receives a lower lifetime benefit/spouse continues to receive 50% of participant's benefit after participant's death | \$1,600/month before income tax | \$800/month before income tax | Monthly - \$400 Annually - \$4,800 Over 10 years - \$48,000 (all before tax) |
| Joint and 100% Survivor Option Participant receives a significantly lower lifetime benefit/spouse continues to receive 100% of participant's benefit after participant's death | 1,400/month before income tax | \$1,400/month before income tax | Monthly - \$600 Annually - \$7,200 Over 10 years - \$72,000 (all before tax) |

With the Pension Maximization strategy using life insurance, the plan participant elects to take the larger Life Only benefit and purchase life insurance to replace the survivor benefits that he or she has forgone.

How the Pension Maximization Strategy Works

- Step 1:** The plan participant purchases sufficient life insurance now (on his or her life) to replace part or all of the survivor benefit that his or her spouse would have received if the Joint and Survivor income option had been elected. The plan participant will need to be insurable to qualify for the life insurance. Since he or she is buying the life insurance prior to retirement, he or she will be paying the premium with his or her own resources. Once pension income begins, he or she can utilize a portion of the pension income to pay any further premiums required.
- Step 2:** At retirement the plan participant elects the Life Only income option from the pension plan (and the spouse waives the Joint and Survivor income option).
- Step 3:** Upon the death of the plan participant, assuming the life insurance policy is in effect, an income tax-free death benefit is paid to the named beneficiary (which should ideally be the spouse, if living).
- Step 4:** The surviving spouse can now use the life insurance to replace part or all of the pension income discontinued as a result of the plan participant's death. This can be accomplished by electing an appropriate life settlement option, purchasing an immediate annuity, or otherwise investing the death benefit proceeds.

Sold properly, this strategy can be very beneficial to the plan participant and his or her family. Sold improperly, this strategy can potentially have adverse financial consequences for the spouse, should he or she survive the plan participant. A primary focus of this guide is to assist you in properly utilizing this strategy for clients who may benefit from it.

Target Market

The ideal candidate for Pension Maximization is someone who meets all these criteria:

- **He/she participates in a defined benefit pension plan.**
A defined benefit pension plan is a plan funded by employer contributions. At retirement the plan participant (i.e., employee) receives a set amount each month, which is based on the employee's salary before retirement and years of service. These types of plans generally offer several types of income options, but do not typically permit the employee to receive a lump-sum distribution.
- **He/she is several years away from retirement.**
Keep in mind that the life insurance premiums are based on age, health, and gender. Therefore, this strategy works best if the decision to utilize the strategy is made 5 to 10 years prior to normal retirement age of 65. However, Pension Maximization may also work even if the plan participant is at or near retirement (though premiums may be higher).
- **He/she is married.**
- **He/she is healthy enough to qualify for life insurance coverage.**

Benefits of the Pension Maximization Strategy

Provides the plan participant with the maximum pension income available for his or her life.

This is particularly advantageous if the spouse of the plan participant happens to die first. If the Joint and Survivor benefit had been elected, the plan participant is generally stuck receiving the reduced benefit even though no survivor benefit will ever be paid. With the Pension Maximization strategy, the plan participant can continue receiving the full Life Only benefit and would still have the ability to access the policy cash value for supplemental retirement benefits via policy loans and withdrawals. (Loans and withdrawals may generate an income tax liability, reduce available cash value and reduce the death benefit or cause the policy to lapse.)

Provides for the surviving spouse through the use of life insurance insuring the plan participant.

Potentially provides emergency funds not otherwise available.

Once the irrevocable election is made to take the Joint and Survivor benefit, the plan participant cannot increase the benefit in the event of a financial emergency. However, if the Life Only benefit is elected and a cash value life insurance policy is purchased, any cash value can be accessed via policy loans and withdrawals for such purposes. (Loans and withdrawals may generate an income tax liability, reduce available cash value and reduce the death benefit or cause the policy to lapse.)

Potentially provides an inheritance for heirs.

- When the Joint and Survivor option is selected, the benefit ends upon the death of the second spouse. This means that there are no funds left for heirs. However, with the Pension Maximization strategy, any life insurance death proceeds left unspent at the death of the second spouse would pass to the heirs.
- If the spouse predeceases the plan participant, the heirs can be named beneficiaries of the life insurance policy and would receive the entire death proceeds.

Beginning this strategy before retirement may provide other benefits, such as:

- Providing pre-retirement death benefit protection for the plan participant's family,
- Eliminating the risk that the plan participant may subsequently become uninsurable,
- Opportunity to build up policy cash values that may help offset some or all of the premiums due after retirement.

The following chart should help to illustrate the potential benefits of the Pension Maximization strategy.

Comparison of Joint and Survivor Option vs. Pension Maximization

| | Joint & Survivor Option | Pension Maximization |
|------------------------------------|---|--|
| While both spouses are living | A reduced pension benefit is received | The maximum pension benefit is received |
| If the plan participant dies first | Spouse continues to receive a reduced pension benefit | Spouse can use the income tax-free death benefit to provide income |
| If the spouse dies first | Plan participant continues to receive a reduced pension benefit for his or her lifetime | Plan participant continues to receive the maximum pension benefit for his/her lifetime and can continue the life insurance policy for heirs or use any cash value to provide additional retirement income* |
| If there is a financial emergency | The pension benefit cannot be adjusted to provide emergency funds | Any cash values from the life insurance policy can be utilized* |
| Heirs | Receive nothing from the pension plan upon the death of the second spouse | Beneficiaries of the life insurance policy can be named |

* Loans and withdrawals may generate an income tax liability, reduce available cash value and reduce the death benefit or cause the policy to lapse.

Although there are many potential benefits for the Pension Maximization strategy, there are also several risks involved. The key is to manage these risks from the outset so as to minimize them as much as possible.

Risks of the Pension Maximization Strategy

The insurance policy that is intended to replace the survivor benefits could lapse prior to his or her death. If the spouse were to survive the plan participant, the spouse could be left without a retirement income stream.

- One way to potentially reduce this risk involves the proper selection of the type of life insurance product to be used. For example, a guaranteed universal life (UL) product could be used. Although there is no guarantee that the insured will continue making the premium payments necessary to keep the policy in force, at least there is the comfort of knowing that the policy will stay in force if the premium payments are made. The advent of products like guaranteed UL has opened up the Pension Maximization strategy to clients who might not otherwise have had the risk tolerance for it.

- Another way to potentially reduce this risk involves the proper design of the life insurance policy. Assuming that a product with a guaranteed death benefit is not used, using more conservative assumptions and taking advantage of guaranteed death benefit riders help to reduce the risk of lapse.

The survivor benefit provided to the surviving spouse may not be sufficient.

- One reason this could occur is that the amount of death benefit purchased may be insufficient. A conservative strategy is to assume a worst case scenario. In other words, assume that the plan participant dies soon after retirement and base the insurance death benefit on the amount needed to provide the surviving spouse with a life annuity based on his/her age at that point in time. As the plan participant gets older, the policy death benefit may be reduced if needed.

- Another reason this could occur is that the interest assumption used for the investment purchased by the policy death benefit (for the purpose of providing the survivor benefit) may be too optimistic. In general, a more conservative rate of return equal to that historically earned by low risk investments such as bonds, short term CDs, and money markets is suggested. Another option would be to utilize a life annuity or life insurance policy settlement option in lieu of investing the death benefit.

Election of the Life Only benefit may cause the spouse to lose his or her medical benefits upon the death of the plan participant.

- Some plans require the surviving spouse to have some continued connection with the employer (such as a pension benefit) in order to continue to be eligible to receive survivor medical benefits. You should review the possible impact on this and other post-retirement benefits before utilizing this strategy. It may be possible for the plan participant to elect a very minimal survivor benefit in order to ensure the spouse continues to be eligible for a survivor medical benefit.

Concept Tips

- Be sure that the plan participant qualifies for the life insurance policy and that it has been issued before he or she waives the Joint and Survivor income option. If the plan participant is uninsurable, his or her only option may be the survivor benefit.

- The spouse may have little or no investment experience. It may be wise to consider a policy settlement option or immediate annuity rather than having a lump-sum death benefit paid to the spouse.
- If the monthly premium is greater than the pension reduction, consider this: Subtract the difference and ask the client if they would be willing to pay the extra in order to receive the extra benefits and flexibility of a personally owned life insurance policy. For example, assume the pension reduction is \$620 a month and the insurance premium is \$700 a month. The question then becomes, would you pay \$80 a month...
 - for the ability to change beneficiaries if your spouse predeceases you?
 - to be able to surrender the policy and receive any cash value while maintaining the higher pension payout if your spouse predeceases you?
 - for your children to receive a death benefit if you and your spouse die in a common accident?
- One way to reduce the monthly premium of the life insurance policy is to transfer 'lazy dollars' and make lump-sum premium payments. For example, assume the client has a \$25,000 CD that is earning 2%. They plan on taking the interest in cash each month to supplement retirement income. The monthly interest comes to \$41.67. By using the \$25,000 as a dump-in payment, the monthly premium for the insurance will be reduced. The result is the client takes the higher pension payout and has a lower monthly insurance premium. Instead of a \$41.67 monthly interest check, the client could realize an increase in monthly cash flow because less pension income is needed to pay life insurance premiums.

Illustrating a Pension Maximization Case

The ING Presents illustration software has the capability to illustrate a customized Pension Maximization case. The easiest way to illustrate a case is to utilize the Pension Maximization Wizard, especially if you are new to this concept or relatively unfamiliar with the ING Presents software. The illustration Wizard contains certain default answers. In general, the defaults were selected to assist you to run a competitive illustration that addresses many of the concerns discussed elsewhere in this guide. Below is a brief discussion of some of the illustration options:

Death of the plan participant for purposes of solving for the necessary death benefit protection is assumed to be immediately after retirement.

Options used to illustrate income from the proceeds of the death benefit include:

- Life Annuity (default) – provides a guarantee of income for the lifetime of the annuitant.
- Interest Only – requires a much higher death benefit, the income cannot be outlived, and the principal remains as a legacy.
- Principal and Interest – liquidating proceeds over a specified period based upon an assumed rate of return.

Survivor benefits will be partially taxable

- Life Annuity (default)- includes an exclusion ratio to determine taxability of the payouts. Once the original investment in the annuity has been recovered (i.e., the life insurance policy death benefit), then the exclusion ratio no longer applies and the annuity payouts become fully taxable.
- Interest Only- illustrated as 100% taxable.
- Principal and Interest- illustrated as partially taxable (i.e., the income portion is taxable).

Income taxes (default) will be included in the Pension Maximization calculations

- The Wizard will allow you to elect to not include income taxes in the calculations.

For more information about Pension Maximization, contact ING Life Sales Support at 866-ING-SELL (866-464-7355).

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