THE PRIVATE PENSION PLAN

April 12, 2017 by Richard Myerson, CPA, CLU, ChFC

A colleague of mine has a wonderful expression: “tax the seeds, not the harvest.” It certainly makes intuitive sense, regardless of the underlying metaphorical product or service. But it has very special consideration when applied to wealth accumulation options.

Consider this: there are only three components to any investment: the deposit, the growth (or gain), and the distribution. And in every investment, at least one of these components must be taxed. For tax-qualified investments (e.g., 401k, 403b, IRA’s, Profit-Sharing, and Defined Contribution and Benefit Plans), the taxes are paid on distributions, while the deposit and the gains are tax-deferred. For assets, outside of a qualified plan (or life insurance policy), the taxes are paid pre-deposit and on the gains as they are accumulated or distributed. Using a life insurance alternative, the taxes are paid only pre-deposit.

Further, consider this: in 2016, the federal government raised $3.3 trillion in taxes and spent $3.9 trillion. Approximately $2.4 trillion went to mandatory programs (social security, Medicare, etc.) while $584 billion went to defense. Only $600 billion went to discretionary programs. The balance was interest on our national debt[1]. So, ask yourself this question: if our spending continues to outpace our revenues (at least in the near-term) and interest rates rise alongside our debt, how long will it take until there is no availability for any discretionary spending? Which naturally leads to the more consequential question: what will the income tax rate be at your retirement?

PRE-TAX STRATEGY

From an early investment age, many of us are taught the advantages of saving money on a pre-tax basis into a qualified plan. However, most individuals, many wealth advisors, and even some tax advisors are not familiar with the extraordinarily tax-efficient benefits of using a life insurance “wrapper” to grow and distribute assets.

This article explores these benefits, looks at, and responds to the most common objections to using a life insurance “wrapper” to grow and distribute assets. If intelligently engineered, the often disparaged “drag” on the growth from mortality charges and other expenses become incidental to the long-term tax-efficient advantages of the strategy.

Taxes are the origin of the advantages underlying the use of this strategy for wealth accumulation. The IRS tax code may just render life insurance the final great, legal tax-avoidance strategy. Why and how? First (and most importantly), the death benefit paid on a life insurance policy is typically tax-free. The “typically” stipulation is added to consider those very limited instances when a policy owner can unintentionally cause the death benefit to be taxable.

Second, the gains inside the policy accumulate on a tax-deferred basis. Third, these gains can be accessed and distributed tax-free. One must be careful in all the above cases to ensure no violation of rules that would modify the tax advantages of the policy. If the rules are properly followed, we have life insurance tax bliss.

Commonly, these plans are called Non-Qualified Plans or Private Pension Plans, and we use them in both a business environment and for individual wealth accumulation. The terminology comes from the distinction that there are no government rules or regulations controlling participation, limiting the amount of contributions or timing of withdrawals, or creating penalties for violating any of the Qualified Plan rules.

- In a business environment, the strategy is used to recruit, retain, reward, and retire key executive management and talent. There are a variety of different structures to creating the plan, but all of them involve two components: the agreement between the employer and employee, and the funding mechanism (in this case, life insurance, to provide the promised benefits). The two components are, and, must, out of necessity, be mutually exclusive to avoid current income tax to the participant. Great care must be taken here to avoid falling foul of certain rules, whereby the employee could be attributed with phantom income in the event of triggering a "constructive receipt" landmine.

- On an individual basis, The Private Pension Plan lines up alongside the client's Qualified Plans and non-qualified other investments, and becomes a component of their overall retirement portfolio.

In my practice, whether we're funding the strategy within a business environment or for personal use, we use the same funding mechanism: Maximum Funded Equity Indexed Universal Life Insurance. Essentially, the engineering of this strategy can be broken into three parts:

EQUITY INDEXED

This component of the strategy allows premiums being invested in the strategy to be linked to an index (e.g., the S&P 500) in the form of options acquired in the index. After the cash (less costs and expenses, as discussed below) is deposited into the contract, the index is measured on an initial measurement date, and is then measured (usually) one year from that measurement date. If the index increases over that period, the net deposited funds increase at the same rate – up to a maximum cap determined by the carrier for each year's segment. If the index decreases during that same period, there is either no impact on the net deposited funds, or they could be credited with a minimum floor set by the carrier. (There are a broad number of crediting strategies with the S&P 500, 0% floor being the most ubiquitous.) At the end of each period, any gain is "locked in," and the next segment begins, with another deposit being made in years two, three, four, etc. The gains earned each year can never be lost. Currently, most companies' cap rates are between 10% and 13%. The product is designed for those individuals who would like upside market participation, but want to avoid market downside swings.

UNIVERSAL LIFE INSURANCE

The life insurance component creates the significant tax advantage of the strategy. While the contribution to the private pension plan is not a deduction from current income tax, similar to that of qualified retirement plans, the gains earned inside a life insurance policy grow on a tax-deferred basis. However, unlike a qualified plan, when taking money out of a life insurance policy, the distributions can be made to be 100% tax-free, if certain rules are properly followed. And as previously noted, unlike qualified plans, there are no rules as to how much money can go into the plan and when money can be distributed from the plan.

MAXIMUM FUNDED

The Internal Revenue Code allows us to deposit cash into a life insurance policy, have that cash grow on a tax-deferred basis, withdraw that cash tax-free, as long as certain tests are met. These tests are designed to avoid a Modified Endowment Contract (MEC), which, if established, would nullify much of the tax-efficiency of the strategy. Therefore, we plan for the policy to have the smallest death benefit relative to the cash being deposited, and hence have the lowest possible costs and expenses while still avoiding a MEC.

- Equity Indexed Life Insurance is the fastest growing cash-value accumulation product in the U.S.[2]. This is no surprise given its tax-efficiency, safety, and flexibility, combined with the ability to achieve higher yields than whole life or ordinary universal life could offer, all without the risk of market volatility. So, it begs the question: why isn't this strategy used by wealth advisors and recommended by all tax advisors to their clients? It's a simple question with not such a simple answer.

Typically, there are one or more of the following issues surrounding the strategy:

- Complexity: many advisors, even some in the life insurance industry, are unfamiliar with the complexities that go into the product, and do not wish to appear less than competent in the eyes of their clients.
- Buy Term and Invest the Difference: this is the antiquated and tired refrain of those who have not taken the time to understand how the product really works, and simply believe life insurance should never be used as an investment.
- High Costs and Expenses: life insurance products have high initial costs and expenses. There is no getting around that fact. Another fact: the asset management fees paid over the life of a managed investment portfolio

can be more than twice as high as those of a similar life insurance investment, even on a net present value basis.[3]

- Us vs. Them: notwithstanding the same client-centric objectives, there exists a “Great Divide” between wealth and insurance advisors when it comes to life insurance as an asset accumulation vehicle. There are understandable reasons for this:
  The inherent age-old industry stigma applied to the life insurance “salesman.” This reality has been created by years of (sometimes deservedly) pounding the life insurance industry for shady sales practices. The psychology of the wealth advisors is to “rise above” a life insurance purveyor (unless specifically requested by the client) and avoid discussing this as an accumulation option.
  Many wealth advisors are not licensed to sell insurance, and those that are not predisposed to having a “one-off” commission hit with assets, thereafter forever removed from their book.
  There is very little, if any, life insurance training provided to asset managers by their firm or broker-dealer, and sales of life insurance are often relegated to intermediaries assigned to the investment firm.
- Taxes: most tax advisors are interested in finding ways to help their clients avoid current income taxes, but are much less focused on the very real possibility of significantly higher tax rates in retirement.

If we had a proverbial crystal ball, we might be able to take a deep look into the future and know what the market will do each year, what tax rates will be when we retire, and even how long we might live (although my guess is that most of us have no desire to know the latter). But none of us do know these things and we can only guess, based (hopefully) on rational inputs. And if we’re truly worth our fees or commissions as financial advisors, we need to make sure at least a portion of our clients’ portfolios are protected from taxation at the time of harvest.

Endnotes
1 2015 Office of Management and Budget, adjusted 2017
2 LIMRA
3 Calculation based on a 39-year-old contributing $50,000 for 12 years into a maximum funded equity indexed life insurance product and the same amount into a managed investment portfolio with a .075% asset management fee. The fees were present valued over the life of each strategy and measured against the total distributions from each strategy over the same time period.