Maximizing Your Pension with Life Insurance

Introduction

If you participate in a traditional pension plan (known as a defined benefit plan) with your employer, you may receive monthly benefits from the plan after you retire. These benefits are generally based on your age at retirement, as well as your years of service and your average earnings with the company. Depending on your plan's provisions, you may have more than one payout option to choose from. You want to select an option that will provide you with sufficient retirement income. In addition, if you are married, you want to be sure that your spouse will have sufficient income in the event that he or she outlives you.

When you retire, a defined benefit plan must offer you and your spouse a joint and survivor annuity. If your spouse consents in writing, you can generally decline the joint and survivor annuity and elect a single-life annuity instead. Some defined contribution plans offer similar options, so consult your plan administrator or benefits department if you participate in one of these plans.

With a joint and survivor annuity, payments continue as long as either you or your spouse is alive. When one spouse dies, the benefits paid to the surviving spouse generally cannot be less than 50 percent (or more than 100 percent) of the joint benefits. By contrast, with a single-life annuity, payments last for your lifetime and cease upon your death. For example, if you received one payment after retirement and then died, the single-life annuity would provide no further payments from your pension. Your spouse would receive nothing.

So why would you choose a single-life annuity knowing that payments will stop at your death? One reason is that the single-life annuity generally pays a larger monthly benefit than the joint and survivor annuity. This is because the payments are designed to last for a smaller number of years (i.e., one life expectancy instead of two). Retirees who want to maximize their monthly income sometimes choose the single-life annuity for this reason. The retiree can then use the additional income to purchase life insurance with his or her spouse as the beneficiary, thereby protecting the spouse's financial future. This strategy, commonly called pension "maximization" using life insurance, may be appropriate for you.

> **Caution:** Be sure to seek qualified professional advice, since choosing a pension payout option and life insurance coverage can be complex and will impact both your financial future and your spouse's.

Factors to consider

Difference in benefits between the two payout options

As mentioned, a single-life annuity pays larger monthly retirement benefits than a joint and survivor annuity. The amount of the difference is a key factor when deciding between the two payout options. This information is generally provided to you prior to distribution as part of the spousal consent/waiver process. If the single-life annuity pays significantly more than the joint and survivor annuity, then electing the single-life annuity along with the purchase of a life insurance policy may be a viable strategy. The larger the monthly benefits under the single-life annuity, the more income you will have to pay the premiums for the life insurance policy. However, if the difference between the two payout options is relatively small, it may be better to elect the joint and survivor annuity. This is especially true if the single-life annuity will not provide enough income to pay the insurance premiums.

> **Tip:** Always consider the impact of federal and other income taxes on annuity payments when determining the net amount of benefits available for you (and your spouse).

Insurability and cost of insurance

If you are not insurable because of your health and/or other reasons, then electing the single-life annuity along with the purchase of a life insurance policy is not an option. If you are insurable, determine how much life insurance coverage would be needed to compensate your spouse for the loss of your pension income if you elected the single-life annuity. Then look at the cost of that amount of coverage, and compare it with your monthly income from the single-life annuity. This will help you decide if using the pension maximization strategy makes financial sense. If you are relatively young and in good health, the insurance premiums may be much more affordable than if you are older and/or in poor health. However, as the cost of the insurance becomes more expensive, using life insurance to maximize your pension payout becomes less attractive.

Cost-of-living adjustment

Some pension plans have a cost-of-living adjustment (COLA) feature that allows the monthly benefits to be periodically increased to keep pace with the rate of inflation. If your pension contains this feature, you may need to consider a larger insurance policy to protect your surviving spouse from the loss of your pension income (assuming you elect the single-life annuity). This is because your surviving spouse would receive an ever-increasing amount of annual income over his or her lifetime if you elected the joint and survivor annuity with a COLA feature, and the rate of inflation goes up over time. Thus, the presence of a COLA clause in your pension plan may be a factor against using life insurance to maximize your pension. You will have to work through the numbers to see if it makes more sense to elect the single-life annuity and buy an insurance policy, or to simply elect the joint and survivor annuity.

Health and life expectancy of your spouse

If your spouse is in poor health or has a short life expectancy, then selecting the single-life annuity along with the purchase of a life insurance policy often makes more sense than selecting the joint and survivor annuity. This strategy is more practical if your spouse is more likely to die before you. As the plan participant and the surviving spouse, you will then have the benefit of the higher monthly payout from the single-life annuity for the rest of your life. You can then choose to discontinue the life insurance policy, or continue to make the premium payments and name a new beneficiary (as long as an irrevocable designation of beneficiary has not been made).

Age difference between you and your spouse

If there is a large difference between your age and your spouse's age (with you being much older), then opting for the single-life annuity along with the purchase of a life insurance policy may make more sense because the difference in benefits between the single-life annuity and the joint and survivor annuity will typically be greater. If your spouse is considerably younger than you, his or her longer life expectancy will be factored into the calculation of the joint and survivor annuity benefits, resulting in smaller monthly payments. This could leave you and/or your spouse without sufficient retirement income using a joint and survivor annuity. However, if you select a single-life annuity that ends because you die soon after retiring, your much-younger spouse may have to survive financially without the benefit of your pension for a long period of time.

Gender of the plan participant

If you (the plan participant) are female and insurable at an affordable cost, then selecting the single-life annuity along with the purchase of a life insurance policy may make more sense than selecting the joint and survivor annuity. The reason: All other factors being equal, women are statistically more likely to outlive men of the same age. You will benefit from the higher monthly payout under the single-life annuity while you are alive, and the life insurance coverage will protect your spouse in the event that you die first. By contrast, if you select the joint and survivor annuity and your spouse dies first, you may be stuck with a smaller payout for the rest of your life (unless the plan has a "pop-up" provision--see below).

"Pop-up" provision

Some pension plans offer their participants a "pop-up" provision specifying that if they initially select a joint and survivor annuity payout and the spouse dies first, they can then retroactively select a single-life annuity payout. This gives you flexibility to adapt if things do not go as planned. If your pension plan offers this option, you may not want to select a single-life annuity with the purchase of a life insurance policy. It may be better to initially select the joint and survivor annuity.

Advantages of maximizing your pension with life insurance

It may increase your retirement income

Most people who use a single-life annuity with life insurance to maximize their pension payouts are trying to increase their income during their retirement years. Under most pension plans (and depending on various factors such as the age of the two spouses), a single-life annuity will pay out substantially more per month than a joint and survivor annuity. Most people would like to have that extra income during their retirement years. However, most people are also concerned about providing for their spouses if they should die first. By selecting a single-life annuity along with the purchase of a life insurance policy on the participant's life, some couples can increase their income during retirement and provide for the surviving spouse's financial future.

It may work well even if the nonparticipant spouse dies first

Using life insurance to maximize your pension payout will work well financially if your nonparticipant spouse should die first. In fact, this strategy may actually produce greater financial benefits if your nonparticipant spouse does die first, because you (the surviving spouse) will receive the higher single-life annuity payout for the rest of your life. You can then either discontinue the insurance policy or name a new beneficiary and continue to pay the premiums.

It may provide assets for your heirs and beneficiaries

Another benefit to selecting the single-life annuity with the purchase of a life insurance policy is that there may be assets left over for your heirs and beneficiaries. If you and your spouse select a joint and survivor annuity, no benefits from your pension plan will be paid to your heirs and beneficiaries (e.g., your children) when the surviving spouse finally dies. If, however, you select a single-life annuity and purchase a life insurance policy on your life, some of the insurance proceeds may still be left for your heirs and beneficiaries after the death of your surviving spouse. This is especially true if your surviving spouse invests the proceeds wisely and does not spend them rapidly, or if your spouse predeceases you and the life insurance proceeds are paid to your beneficiaries upon your death.

Disadvantages of maximizing your pension with life insurance

The income earned on the insurance proceeds may not meet expectations

This strategy may not work well if, for some reason, the investment earnings on the insurance proceeds are too low to adequately provide for the surviving spouse. To illustrate, consider the following hypothetical scenario.

> **Example(s):** Upon your retirement, you select a single-life annuity for your pension and purchase a $300,000 life insurance policy on your life with your spouse as beneficiary. Based on market conditions at the time of your retirement, you believe that the earnings generated by the insurance proceeds will provide sufficient income for the rest of your spouse's life if you die first. You die three

years later, when market conditions have deteriorated substantially. The life insurance proceeds may now not provide enough income for your surviving spouse.

Your surviving spouse may squander the insurance proceeds

Another potential problem with this strategy is that your surviving spouse may make poor investments with the insurance proceeds, spend them too quickly, or otherwise squander the money. If this happens, your surviving spouse may be in a difficult financial situation for the remainder of his or her lifetime. With the joint and survivor annuity, you minimize this risk because your surviving spouse would at least be assured of receiving the designated pension payout each year.

The life insurance policy may lapse

If you choose to maximize your pension with life insurance and then stop paying the insurance premiums due to financial problems or other reasons, the insurance policy may lapse. With no insurance proceeds and no pension benefits, your surviving spouse may be in a difficult financial position after your death. In this case, your surviving spouse would have been in a much better position if the two of you had selected the joint and survivor annuity for your pension.

When this strategy makes sense: a short case study

Example(s): Assume you are about to retire at age 65, and your spouse is age 62. Your pension plan gives you the option of either a single-life annuity or a joint and survivor annuity. If you select the single-life annuity, you will receive $4,500 per month for the rest of your life, but your spouse will receive nothing if you die first. If you select the joint and survivor annuity, you and/or your spouse will receive $3,000 per month as long at least one of you is alive. That's an additional $1,500 per month (or $18,000 per year) with the single-life annuity.

That sounds attractive, but what will happen to your spouse if you select the single-life annuity and you die before your spouse? Your spouse gets no survivor benefit. Your spouse may need a way of replacing that lost pension income. One way to accomplish this may be to purchase a life insurance policy on your life, and name your spouse as the beneficiary of the policy.

You need to determine whether the extra $1,500 per month under the single-life annuity (less income taxes) will buy enough insurance coverage to produce a replacement income of $3,000 per month if you die before your spouse. That is the amount of income your spouse would have received had you selected the joint and survivor annuity. You also need to determine whether your spouse will live off of only the income from the insurance proceeds, or need to dip into principal as well. You must run the numbers to see what is affordable and what makes financial sense.

Income tax considerations

The monthly retirement benefits you and your spouse receive from your pension are generally treated as taxable income, subject to federal (and possibly state and local) income tax. This is true regardless of whether you elect a single-life annuity payout or a joint and survivor annuity payout. However, since the pension benefits are larger with a single-life annuity, electing this payout option will increase your taxable income during retirement.

If you elect the joint and survivor annuity payout, when the first spouse dies, the pension payout to the survivor will be included in the survivor's taxable income. If you instead use the pension maximization strategy and die before your spouse, the life insurance death benefits will not be included in your surviving spouse's taxable income. This is because life insurance death benefits generally pass free from income tax to the beneficiary of the policy. Of course, your surviving spouse may invest the insurance proceeds in taxable investments. Any earnings from such investments (e.g., interest, dividends, and capital gains) will generally be included in your spouse's taxable income.

> **Caution:** While life insurance proceeds are generally free from income tax to the beneficiary, estate taxes are another matter. If this is a concern, you should consult a qualified estate planning attorney for appropriate strategies.