Qualified Plan Maximization

Life Insurance Funding with Qualified Plans

Many of your clients have worked very hard to save for retirement. They put as much money as allowed by tax laws into their 401(k) plans, traditional IRAs, and other qualified savings vehicles. Now that they are nearing retirement, some may find that they no longer need all of these assets to supplement their income. In fact, many of these clients may tell you that they plan to leave these assets alone so that their children can enjoy a larger legacy. Unfortunately, it may not be so easy for your clients to accomplish this goal.

The Concern

Qualified retirement plans such as 401(k)s and traditional IRAs are an excellent way to save for retirement. They allow your clients to put away money pre-tax, and then allow that money to grow tax-deferred. However, at age 70½, your clients must start taking Required Minimum Distributions (RMDs) from their plan, whether they need the additional income or not. These RMDs will be income taxable when withdrawn from the plan. Furthermore, because the qualified plan assets were not taxed during life, they can be taxed twice at your client's death: by income taxes in respect of a decedent (IRD taxes) and by estate taxes. In some cases, this double-whammy can erode the amount passed from your client to the heirs by as much as 70%.

Fortunately, there is a way your clients can use their qualified plan assets to help increase the amount of money left to their heirs. It is called Qualified Plan Maximization (QPlan Maximization).

The Solution

QPlan Maximization is a way for your clients to move assets from their qualified plan and use them to purchase life insurance in order to potentially increase the amount that is transferred to heirs. If estate taxes are a concern, your client may want the insurance to be owned by an Irrevocable Life Insurance Trust (ILIT)[1]. When properly drafted by the client's attorney to comply with the appropriate state laws, this ILIT can purchase life insurance on the client (and spouse, if desired).

How It Works

First, your client takes a withdrawal from the qualified plan and pays income tax on this withdrawal. Then, the client can use all (or part) of the income to pay premiums on a life policy.

Life insurance is an efficient asset to transfer to heirs because the proceeds are not subject to ordinary income taxes when paid to the beneficiary at death. If the policy is owned by a properly drafted ILIT, it will not be subject to estate taxes either.[2]

Benefits

- Life insurance can increase the amount left to heirs.
- Life insurance grows tax deferred, cash surrender value can be accessed tax-free (through withdrawals and loans)[3] and the death benefit can be received tax-free.
- Life insurance, depending on the state, can provide creditor protection.
- Life insurance, in a properly drafted ILIT, can help reduce estate taxes.

Considerations

Taking Withdrawals *Before* Age 59½. Clients who have not yet reached age 59½ will generally be subject to a 10% penalty tax on withdrawals that they take. The exception to this rule is if the client takes "substantially equal periodic payments" calculated annually based on the client's age and the IRS's life expectancy tables. Distributions that qualify as substantially equal periodic payments will not be subject to the penalty tax; however, once clients begin taking such payments, they must continue to take them every year.

Taking Withdrawals *After* Age 59½. Clients who have reached age 59½ may take withdrawals at their discretion without penalty and have a greater degree of flexibility. How much to withdraw generally depends on the size of the insurance need and the number of annual gift tax exclusions available to the client. Many clients chose to withdraw enough each year to match their available annual gift exclusions and pass that amount gift tax-free to the ILIT. If there are enough annual exclusions available, the client can also increase the gift to the trust to match the after-tax RMDs that will be applied when the client reaches age 70½.

Repositioning RMDs. Clients who have already started taking RMDs may find that simply using the after-tax RMD to fund life insurance in an ILIT provides substantial leverage and can greatly increase the amount left to their heirs.

Plan requires evidence of insurability.

Life insurance may have fees associated with it, such as the cost of insurance.

CASE STUDY: STEPHEN AND MARY HAINES

CLIENTS: **Stephen and Mary Haines**

STATUS: Ages 71 and 70, Preferred Non Smokers. They have a qualified plan worth $1,500,000, growing at 8% annually.

PRODUCT: Take withdrawals from qualified plan, use the after-tax amount to purchase a Current Assumption Survivorship Universal Life policy which buys $2,650,000 with an annual premium of approximately $40,000.

COMPARSION OF VALUE IN YEAR 24

		CURRENT STRATEGY	PROPOSED STRATEGY
Qualified Plan Value Today		$1,500,000	$1,500,000
Total Premiums Paid by Year 24			$960,000
Qualified Plan in Year 24	+	$1,963,618	$1,963,618
Death Benefit in Year 24	+		$2,650,000
Less Income in Respect of Decedent Taxes	-	$687,266	$687,266
Saved Income in Year 24 @ 5.00%	+	$3,798,105	$1,929,021
Net to Heirs in Year 24	=	$5,074,457	$5,855,373
Potential Gain Due from Planning			$780,916

The figures used in this case study are hypothetical, for discussion purposes only, are not guaranteed and may not be used to project or predict results. Actual results may be more or less favorable. Specific product and policy elements would be found in a policy illustration provided by an insurer. With any decision regarding the purchase of life insurance, a client would need to determine which type of life insurance product is most suitable for their specific needs.

SUMMARY

Some clients reach retirement and find that their needs change. Use JH Solutions to show your client how QPlan Maximization can help reduce estate taxes, reduce IRD taxes and leverage withdrawals to create a lasting legacy for their heirs.

1. Trusts should be drafted by an attorney familiar with such matters in order to take into account income and estate tax laws (including the generation-skipping transfer tax). Failure to do so could result in adverse tax treatment of trust proceeds.
2. Life insurance death benefit proceeds are generally excludable from the beneficiary's gross income for income tax purposes. There are a few exceptions such as when a life insurance policy has been transferred for valuable consideration.
3. Loans and withdrawals will reduce the death benefit, cash surrender value, and may cause the policy to lapse. Lapse or surrender of a policy with a loan may cause the recognition of taxable income. Policies classified as modified endowment contracts may be subject to tax when a loan or withdrawal is made. A federal tax penalty of 10% may also apply if the loan or withdrawal is taken prior to age 59½. Cash value available for loans and withdrawals may be more or less than originally invested.

This material does not constitute tax, legal or accounting advice, and neither John Hancock nor any of its agents, employees or registered representatives are in the business of offering such advice. It cannot be used by any taxpayer for the purpose of avoiding any IRS penalty. It was written to support the marketing of the transactions or topics it addresses. Comments on taxation are based on John Hancock's understanding of current tax law, which is subject to change. Anyone interested in these transactions or topics should seek advice based on his or her particular circumstances from independent professional advisors.

For Financial Professional Use Only. Not intended for use with General Public.

Insurance products are issued by: John Hancock Life Insurance Company (U.S.A.), Boston, MA 02116 (not licensed in New York) and John Hancock Life Insurance Company of New York, Valhalla, NY 10595.

Scan this code to find out more.

© 2013 John Hancock. All rights reserved.

IM1350 11/13 MLINY02281318321