Survivor Supplemental Retirement Income

Funded with Life Insurance

What Is Survivor Supplemental Retirement Income Funded with Life Insurance?

Survivor supplemental retirement income funded with life insurance is an alternative to the company-provided survivor income options, using life insurance. It involves a two-step procedure that combines a life income option annuity election with life insurance on the retiring worker's life. By electing the full annuity benefit from a retirement plan, the worker receives the maximum monthly retirement benefit for life.

Survivor supplemental retirement income funded with life insurance can also help provide added flexibility and other benefits to the couple. However, it is usually not appropriate if the retiree is in poor health.

Background on Survivor Supplemental Retirement Income Funded with Life Insurance

Every married retiree who participates in a retirement plan will be faced with an important economic decision. At or before retirement, every worker should decide how to arrange his or her payout. It's not an easy decision: Whether to choose all the monthly income the worker is entitled to by electing a life income option, or settling for what can be a hefty cut in benefits to provide a retirement income for the surviving spouse. What makes the decision even more difficult is this decision is often irrevocable after retirement begins. Note, however, that survivor supplemental retirement income funded with life insurance is usually not appropriate for an employee close to retirement, or when the retirement plan provides an inflation-indexed payout.

Joint-and-Survivor Annuity Requirement

It is imperative that workers consider and calculate the impact of the tax law rules on themselves and their spouses before a supplemental retirement payout decision is made. Current law requires that a pension plan automatically provide a participating retiree with a qualified joint-and-survivorship annuity as a payout option. They should contact their tax adviser for assistance with this decision.

This annuity must provide:

- annuity benefits for the life of the retiree, and
- a survivor annuity for the life of the spouse that is not less than 50% nor more than 100% of the retiree's benefit.

To depart from the standard form of benefit, the spouse must consent in writing to a waiver of the worker's survivorship benefits.

Providing a survivorship annuity can result in a substantial decrease in the monthly benefit paid to the retiring worker. This mandatory-unless-waived provision exposes pension benefits to a risk that a survivor benefit will not be paid if the spouse dies first. Some plans do, however, contain a so-called "pop-up" provision, which increases the worker's benefit if the spouse dies first.

And if the retiree remarries, there is no benefit for the new spouse, yet reduced supplemental retirement income payments continue for life. Unless the retiring worker opts out of the survivorship annuity, the retiree has to settle for quite a bit less to provide for a contingency that might not even happen, namely, the survival of the spouse.

It's not an easy decision and it's compounded by the fact that the couple faces twin risks. If the spouse outlives a retiree who has waived the survivorship option and taken the maximum monthly benefit available, the surviving spouse could be left with little security during retirement.

How Much Are Benefits Reduced?

The amount of the reduction depends on the age of both the worker and the spouse. The younger the spouse, the greater the reduction.

For illustrative purposes, let's assume that, in order to elect a joint and equal survivor benefit—where the same monthly payment continues to a surviving spouse—a worker might receive 75% of what would otherwise be

available under a life income option. The table that follows shows what that cost could amount to over a period of time.

Dollar **Loss in a** Joint-and-Equal-Survivor **Benefit** (25% Reduction)

Monthly Life Income Option	1 Month	1 Year	10 Years	20 Years
$500	$125	$,500	$15,000	$
1,000	250	3 ,000	30,000	60,000
1,500	375	4 ,500	45,000	90,000
2,000	500	5 ,000	60,000	120,000
2,500	625	7 ,500	75,000	150,000
3,000	750	9 ,000	90,000	180,000

Under these assumptions, a worker who might otherwise receive a $1,500 maximum monthly benefit could be faced with a monthly loss of $375 if he or she elected a joint-and-survivor benefit. This translates into a $45,000 loss over 10 years and a $90,000 loss over a 20-year period. Before workers elect less than the full life annuity benefit or let the government make the election for them, they should consider the consequences.

High Cost

The cost is obvious—a substantial reduction in monthly benefits to pay for a contingency that may not happen. Though a few plans may include a "pop-up" provision which reinstates the worker's full benefit if the spouse dies first, there is still no recovery of the amount tnat was lost during the spouse's life.

Irrevocable Decision

Within 90 days of when benefits are to begin, the worker must make an election. Absent formal action, the survivorship election is automatic. After benefits begin, the election is irrevocable except in those few plans with a "pop-up" provision.

Benefits of Payout Alternatives

Alternatives are available to enhance supplemental retirement income benefits. The retiree may be better off purchasing a life insurance policy which would provide the worker and surviving spouse with a benefit equal to the maximum benefit. It's a two-step procedure that can result in greater supplemental retirement income for married workers and their spouses. Of course, the worker must be able to qualify for life insurance.

Step one: The worker buys a life insurance policy on his or her life and names the spouse beneficiary. If the worker is not in good health, he may not be able to obtain insurance or it may be very costly. The plan is designed so the proceeds from the life insurance are used to create a fund that will pay a lifetime supplemental income to the spouse which is equal to the pension benefit should the spouse survive the retiree. The death benefit can be structured to create a capital account. Earnings are withdrawn from the account and paid to the surviving spouse, or the plan could be structured so that a settlement option provides supplemental lifetime income to the surviving spouse.

Step two: Once the policy is issued, the worker usually elects the life income option from the retirement plan. The payments end when the worker dies.

Benefits of This Alternative

Survivor supplemental retirement income funded with life insurance can also offer attractive additional benefits. First, life insurance provides extraordinary flexibility. If the spouse dies first, the policy can be surrendered and the retiree can use the cash surrender value to supplement retirement income. Or the policy may be continued for the benefit of surviving family members.

Second, policy cash values accumulate on a tax-deferred basis.

Third, retirees who remarry can use the life insurance to help provide benefits to a new spouse.

And finally, the surviving spouse is provided with maximum control over the insurance proceeds. Life insurance proceeds can be used to help meet a wide variety of income and planning needs. And benefits can be received as a single, tax-free lump sum or through a variety of settlement options.

Tax Considerations

Payments made to retired workers are fully taxable when all contributions to the plan have been made by the employer. Insurance policy death benefits paid as a lump sum, on the other hand, are not taxable as income to the beneficiary. Generally, the interest earned on proceeds held by the insurer under a settlement option is taxable as it's received.

Death benefits taken over a period of time as an annuity are taxable only to the extent that an annuity payment is deemed to represent income. A certain portion of each payment is considered a return of capital. The taxable portion of each payment is calculated by applying an appropriate exclusion ratio. This ratio reflects the portion of yearly annuity payments that can be excluded from gross income.

Planning Considerations

Survivor supplemental retirement income funded with life insurance may offer the best of both worlds—

- the greatest pension income available to a retiring worker, and
- the assurance that a spouse who survives the retiree may not have to suffer severe financial loss if the retiree dies.

That can translate into higher supplemental retirement income for both spouses for as long as they live.

Who should consider this two-step plan to greater supplemental retirement income? It is best suited for healthy people in their forties or fifties who are married and who are currently employed and covered by a company pension . . . or any prospect or client who is concerned about providing retirement income for self and spouse.

Advantages

A plan for survivor supplemental retirement income funded with life insurance may:

- Help provide the maximum amount of supplemental retirement-plan income to a retiring worker.
- Help assure that the spouse who survives will not suffer a loss of income after the pension earner's death.
- The cost of the insurance can generally be paid out of the additional income that is received under the retiree's life income option—often with a significant surplus.
- If the spouse predeceases the retiree, policy cash values can enhance the retiree's income. Withdrawals and loans will affect policy values and death benefits and may have tax consequences.

Disadvantages

If the costs of insurance are not paid, and the insurance lapses, the spouse will lose the supplemental income intended by the arrangement.

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