Protecting a Surviving Spouse: Strategies Using Life Insurance and Annuities

Life insurance and annuities can be powerful tools for spousal protection when structured correctly. Are your clients' beneficiary designations and planning strategies aligned for tax efficiency and long-term security for a surviving spouse?

Life insurance and annuities aren't just insurance products—**they're powerful tools for legacy planning, protection, and long-term security.** While naming a spouse as the beneficiary might seem straightforward, the strategy behind it can significantly influence tax efficiency in retirement, as well as wealth preservation and transfer.

How Life Insurance Can Provide Security and Facilitate Wealth Transfer

Although the primary purpose of life insurance is death benefit protection, when used strategically, it can play other critical roles. With careful planning, cash-value life insurance can offer access to loans or withdrawals of cash value. And life insurance can also help facilitate wealth transfer.

1. **Access to cash value:** Cash value life insurance policies such as whole life or indexed universal life (IUL) can build cash value over time.
   - Policyholders can access this cash value through loans or withdrawals, which are typically tax-free[1] when handled appropriately. Cash value distributions are not taxable and won't affect taxes on Social Security retirement benefits or Medicare surcharges.
   - A client could potentially take a loan or withdrawals during down markets to avoid withdrawing from other investments. If this is the plan, then a life insurance policy with certain guarantees may reduce the likelihood of needing additional premiums to support the policy in future years.
2. **Wealth transfer:** Understanding a client's estate and legacy planning goals is just the beginning; the equally important next step is navigating the rules that govern how different assets transfer at death, which is the science of estate planning.
   - Life insurance plays a key role in this process with income-tax-free death benefits. A death benefit can provide financial support to a beneficiary who may be a surviving spouse, help cover funeral and memorial expenses, or be invested if immediate income isn't needed.
   - For larger estates, life insurance can help offset potential estate-tax liabilities and may be used to fund a bypass trust or an irrevocable life insurance trust (ILIT) as part of a broader legacy plan.

Annuities Can Provide Payments Over Two Lives and Facilitate Legacy Planning

Annuities can provide payments guaranteed for life or over the lives of both spouses. When structured properly, annuities can supplement a surviving spouse's retirement income, reduce financial stress, and provide a layer of security that could last for years. They also include legacy-planning benefits.

[1]For federal income-tax purposes, tax-free income assumes, among other things: (1) withdrawals do not exceed the tax basis (generally, premiums paid minus prior withdrawals); (2) policy remains in force until death (any outstanding policy debt at the time of lapse or surrender that exceeds the tax basis will be subject to tax); (3) withdrawals taken during the first 15 policy years do not cause, occur at the time of, or during the two years prior to, any reduction in benefits; and (4) the policy owner does not become a modified endowment contract. See IRS section 72, 7702(f)(7)(B),7702A. Any policy withdrawals, loans, and loan interest will reduce policy values and may reduce benefits.

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1. **Payments:** Annuities are designed to provide protected lifetime payments, which can be guaranteed over two lives (Joint Life), ensuring a spouse can continue income that will not run out.
   - Depending on the type of annuity, payments can be set up immediately or be deferred.
   - Lifetime payments at steady intervals can be set up through annuitization or an income benefit that is often optional for an additional charge. If clients choose to annuitize a nonqualified annuity, income amounts may be only partially taxable because of the exclusion ratio, which treats each payment as part principal and part earnings. If an annuity is qualified (as in an IRA), all withdrawals and payments are fully taxable. With living benefits, income also may last over two lives, and these benefits are designed to ensure future income is protected from market volatility during the accumulation phase, which might increase income over both lives compared to annuitization.

Whether annuitizing to create a steady cadence of payments or using a living benefit, structuring joint lifetime payments for spouses is an important component of annuities that can help ensure a widow or widower can maintain income for life.

1. **Legacy planning:** Annuities typically include a beneficiary benefit.
   - A standard beneficiary benefit ensures any remaining contract value goes to the beneficiary. Enhanced benefits may be available that can deliver more value for an additional cost. While the beneficiary benefit is not income-tax-free the way death benefits are with life insurance,[2] the beneficiary—if a surviving spouse—is not required to take a lump-sum distribution or pay taxes immediately.
   - If the surviving spouse is the sole primary beneficiary, he or she can elect to continue the annuity contract as the owner. This option allows the spouse to maintain tax deferral and control the timing of distributions, which can be a valuable strategy for managing taxable income over time.

Don't Overlook Roles that Life Insurance and Annuities Can Play

Life insurance and annuities can be powerful tools in retirement planning, especially when the goals extend beyond accumulation to income stability and legacy planning. Life insurance offers tax-advantaged access to cash value and estate-planning benefits, while annuities provide reliable, customizable payments, including Joint Life and spousal continuation options. Used strategically, life insurance and annuity strategies can help clients manage taxes, reduce market risk, create sufficient cash flow and transfer wealth across generations. For financial professionals, integrating these solutions can strengthen retirement plans and deliver long-term value.

ACTIONS YOU CAN TAKE RIGHT NOW

- **Identify clients who may need additional lifetime income.**
- **Evaluate whether or not tax-deferred annuities or life insurance may be an option for your clients.**
- **Review client beneficiary designations and implement additional income strategies as needed.**

[2]For federal income tax purposes, life insurance death benefits generally pay income tax-free to beneficiaries pursuant to IRC Sec. 101(a)(1). In certain situations, however, life insurance death benefits may be partially or wholly taxable. Situations include, but are not limited to: the transfer of a life insurance policy for valuable consideration unless the transfer qualifies for an exception under IRC Sec. 101(a)(2)(i.e. the transfer-for-value rule); arrangements that lack an insurable interest based on state law; and an employer-owned policy unless the policy qualifies for an exception under IRC Sec. 101(j).

A beneficiary benefit is referred to as a death benefit in the prospectus or contract summary.

Additional Resources and Links

[Understanding Your Options as the Beneficiary of an Annuity]

[How The Giving Season Can Inspire Legacy Planning]

[Wealth Transfer Strategies]

[Life Insurance for Retirement Planning (LIRP)]

For more information about retirement planning, please contact our Retirement Strategies Group at RSG@PacificLife.com or (800) 722-2333, ext. 3939.

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