C Corporation + Whole Life Retirement Scheme – Friday Q&A

Q.

I am a Texas physician grossing around $500,000 per year (39.6% bracket). I anticipate cutting back to 1/2-2/3rds of that income in about 8 years when I hit 50. I plan to save around $150K per year toward retirement until that time, more than I can put into my available tax-protected retirement accounts. My tax accountant is suggesting a scheme where I use a C Corporation plus whole life insurance for a tax deduction. The plan is very complicated, building my skepticism. It seems to run like this:

I am an independent contractor running a PLLC taxed as an S-corp. I then also start a C-corp management company. A C-corp is taxed at 15% up to $50K and 25% for the next $25K. The effective tax rate for $75K
profit in the C-corp is 18.33% or $61,250. If I am at the 39.6% tax bracket that becomes $12,900 tax savings if I divert that money to the C-corp.

Normally the C-corp profits would go back to me and then I would have to pay personal income tax on that. Instead that money in the C-Corp after taxes ($61,250) is used to purchase whole life insurance and over fund it. This money is now in a qualified vehicle that can be invested and grow tax free and can be taken out at any time without a penalty. There is a cost to buy the life insurance I believe the cost is ~3K. I would then somehow borrow the money from the C corporation to avoid taxation or I'd have to use it to buy a second insurance policy. The accountant estimated returns at 5% and annual insurance expenses at $3K/year.

My question now is, have you ever heard of anything like this, and does it make sense?

A.

I'm always very skeptical of complicated schemes. As a general rule, complexity favors the issuer/advisor, and not the client. I'm also very skeptical when I see extremely creative schemes that use financial products in ways that they really aren't designed for. Mixing insurance and investing is a good example. C Corporations also don't generally make sense for physicians due to the double taxation issue – it's either taxed first at the corporate tax rate, then taxed at your personal dividend rate or it is paid to you as salary on which you pay your full marginal tax rate (and applicable payroll taxes.) Now you're talking about a scheme that combines both of these products and somehow morphs the combination into an extra retirement account for you.

Taxable Accounts Aren't That Bad

The first thing to keep in mind when considering schemes like this is that you're always comparing it to a taxable investing account. A taxable account has it's downsides, no doubt, including taxes and less asset protection than many other financial products. However, it also has many positives. You can dip into it at any time and for any purpose. Taxes can be minimized through tax-loss harvesting, the step-up in basis at death, donating appreciated shares to charity, and using only tax-efficient investments such as index funds and municipal bond funds. You should also wait a year prior to taking any gains so you're only paying at the lower long-term capital gains rates. Many people pay hardly any taxes at all on their taxable investing accounts (mine actually saves me taxes.) Advisors like to make it sound like some boogey-man to be avoided at all costs. Always remember there are far worse retirement investing methods than a simple taxable mutual fund or brokerage account.

Life Insurance Isn't A Tax Deduction

Life insurance premiums, as a general rule, aren't tax deductible. That combined with additional costs (insurance costs and fees) generally makes it inferior to most retirement accounts. 5% is also an exceedingly optimistic projection for future returns on a whole life policy bought today. Your more likely returns will be in the 3-4% range, and that's after 3-5 decades of holding the policy. You also need to make sure your policy would be paid up in 8 years, since you don't want to be having to make those huge premium payments on your expected lower income later. You should also consider that putting 50% of your retirement savings into whole life insurance, even if you were a big believer in it, would create a ridiculously imbalanced asset allocation.

Costs Matter

Forming a C corp, dealing with the administrative and tax hassles of that corporation, and purchasing and maintaining not one, but two whole life insurance policies (one inside and one outside of the C corp) adds a lot of additional hassle, complexity, and expense. Those expenses come directly out of your investment returns. I doubt that some slight tax savings will make up for the additional costs and lower returns of the whole life policies.

Roccy DeFrancesco Weighs In

Roccy DeFrancesco, JD, is the author of several books aimed at financial issues for physicians. We don't agree on every financial subject, but since his books cover a lot of complex schemes like this one (some of which he likes, some of which he doesn't), I thought I'd ask him his opinion of this one, and I liked his explanation of it enough to quote it nearly verbatim below:

What you have been pitched has been around since the beginning of time (or so it seems). You create essentially a bogus C-Corp that you never had before and funnel income to that entity. Usually it's a management company. Then the entity retains earnings (pays corp. tax on its income). Because income is taxed at fairly low rates for modest amounts of income (income tax rates that are lower than your own) it seems like an interesting idea.

Then you have the C-Corp buy a cash value life policy where the money is allowed to grow in a tax-protected manner. So it's not the tax deductible purchase of life insurance, it's buying insurance with what the client sees as after-tax income taxed at a lower rate. The problem is that the assets accumulated in the C-Corp are treated as retained earnings. This means that if you want to get the money out of the C-Corp you have to pay taxes on that money when you take it out. That's why promoters of this say that when you get to retirement you would have the C-Corp take a tax free loan from the life policy and then lend that money to the C-Corp owner. This feels like getting the money out of the C-Corp tax free, but that's not exactly true.

Any loan from the C-Corp has to be at a fair market rate (defined by the IRS) with compounding interest. The long-term AFR is currently 3.28%. That loan will have to be paid back at death somehow. Since the policy is owned by the C-Corp, the death benefit from the policy isn't going to be helpful to pay back the loan. So, you'd typically have to buy a separate policy (typically an increasing death benefit policy) on an individual basis with truly after-tax money to be used to pay back the C-Corp upon deah. Then you have a C-Corp with retained earnings and earnings on the retained earnings which is a really crummy asset to give to the heirs who then have the tax problem with the retained earnings.

Some promoters suggest that as soon as you retain the earnings and every year thereafter you take a loan from the

C-Corp and buy the life policy individually. This is problematic because it can be seen as a step transaction- meaning that except for the tax benefit, you wouldn't have done steps 1, 2, and 3. While each individual step wouldn't cause a problem with the IRS, when you put them all together solely to gain a tax benefit, it's a step transaction and any tax benefit is going to be taken away from you. Bottom line is that I am not a fan of this type of tax play and I don't recommend it.

Tom Martin, CFP, is a fan of good Variable Universal Life policies in situations like this. Even if you wanted to use a VUL or WL policy, I think you could reasonably do that outside of any corporate shell. I don't see the tax savings there worth the hassle or complexity. I certainly couldn't condone putting all $75K into cash value life insurance but I don't think $10-25K per year would be any great financial sin, as long as you understand all the downsides of mixing investing and insurance. If I were you, I'd look very seriously at a defined benefit/cash balance plan instead. Schwab offers a personal DBP for independent contractors such as yourself. Personally, I'd probably just use the additional savings above and beyond what I could stuff into a 401K/profit-sharing plan, a defined benefit plan, personal and spousal backdoor Roth IRAs, 529s for the kids, and a stealth IRA, to pay down debt (remember Texas has very nice homestead asset protection laws) and invest in a taxable account.

What do you think readers? Where should this physician put his additional retirement savings? Comment below!