

## **Section 6**

### **Understanding Life Insurance**

#### **INTRODUCTION**

Like it or not, life insurance, for most people, is the foundation or starting point for any financial plan. The exception is for non-married people who have no children and no heirs they are trying to protect or pass wealth to.

Why the starting point or foundation?

Well, that begs the question: Why do people buy life insurance? There are many reasons some of which everyone knows and some reasons that are not widely known.

Here are the traditional reasons people buy life insurance:

1) **To protect a loved one.**

This is the most obvious reason people buy life insurance. Young couples get married; and, if one is the primary breadwinner, coverage is purchased to make sure the other is taken care of in the event of an early death of the breadwinner.

Certainly, for those who have children, life insurance is a necessity. It is needed to take care of the children until they reach a certain age. For some that will be age 18; for others the death benefit will also help pay for college.

2) **To cover a debt** (current or future).

Many people buy mortgage protection insurance. This type of policy simply pays off the mortgage so the remaining spouse or loved one(s) are not burdened with the payments from a mortgage.

A future debt that some buy life insurance for is funeral expenses. These policies typically have no underwriting and are fairly inexpensive to cover usually up to \$15,000 in costs. Some policies come with additional services to help loved ones navigate the funeral home process.

3) **To pass wealth to the heirs and/or cover estate taxes.**

With the estate tax exemption being more than \$10 million per person, most people will not be buying life insurance to cover estate taxes.

Some people will, however, buy life insurance because they want to pass a specific amount of life insurance to their heirs at death (like \$100,000 to each child or grandchild).

Here are a few reasons that most people **do NOT know about** that are valid reasons to buy life insurance.

1) **To build wealth for retirement.**

To many, the concept of building wealth for retirement in a life insurance policy seems counterintuitive.

Why would anyone want to build wealth for retirement in a “cash value” life insurance policy?

-What if the policy allowed money to grow tax free?

-What if the policy could generate a rate of return of between 6%-8%?

-What if gains in the policy were locked in every year and could never be lost due to a downturn in the stock market?

-What if you could remove money from the policy tax free in retirement?

What many people don't know is that a “good” cash value life insurance policy can be a tremendous retirement vehicle.

## 2) **For Long-Term Care (LTC) type benefits.**

Most people do not know that many life policies today come with a **FREE** rider that will pay for long-term care type expenses through what is called a chronic illness rider. This is not a reason alone to buy life insurance; but if you are going to buy life insurance, buying one with this type of rider will make sense.

Since more than 50% of all Americans will have LTC expenses sometime during their lifetime, it would be prudent to have a life policy that could cover some of those costs.

If you are wondering why the material isn't elaborating on the topics covered, that's because each will be covered in more detail in the material to follow.

### **Introduction Summary**

What the introduction material is trying to convey is that life insurance for most people will be the starting point of their financial plan. It can be used to protect loved ones, pay off debts, pass wealth to the heirs, be used as a retirement vehicle, and can even be used to pay for long-term care expenses.

There are many types of life insurance policies available in the marketplace today. This material will break them down into two categories — the “originals” and the “hybrids.” In addition to these types of products, the material will also point out pitfalls to policies and tricks insurance agents use to make the purchase of a policy much more advantageous.

Notwithstanding the cautionary language in the previous paragraphs, life insurance can be one of the best financial planning tools you have at your disposal. What other planning tool do you have at your disposal where in day one you can contribute a monthly premium of \$500 and have an immediate payout to a beneficiary of \$1,000,000? What other product can you use in a supplemental retirement plan that is self-completing?

What does self-completing mean? Three things can happen to you after you buy a life insurance policy. You can live, die, or become disabled. A properly structured life plan can provide or complete itself no matter which of the three happens. Either you or your beneficiaries will receive money from the policy.

The following pages will discuss the types of life products available so you will see why the words “Life Insurance” should NOT be taboo.

### **THE BASICS**

The material to follow goes into detail on the various types of life insurance policies, how they work, and who is a candidate for each type of policy. Before getting into the more detailed information, the basic concept of how a death benefit is paid needs to be dealt with. The following applies to every type of individual life insurance policy.

#### **Proceeds Payable at Insured's Death**

One of the unique and beneficial aspects of life insurance is that the death benefit, when paid to the beneficiary, is generally done so income tax free (IRC Section 101(a)(1)).

There are some exceptions to the general rule that life insurance death benefits are paid income tax free. These include life insurance purchased in a corporate setting where the premium is deducted or purchased by an employee in a qualified retirement plan (not discussed in this course).

While death benefits generally pay income tax free to the beneficiary, they will **NOT** pass estate tax free through the estate to the heirs/beneficiaries (unless the benefit is being passed to a surviving spouse who then will have the estate tax problem). If your estate is in excess of the estate tax exempted amount (\$11.4 million if single), you can still pass the death benefit to your heirs tax free by using an Irrevocable Life Insurance Trust (ILIT); but that is outside the scope of this course material.

### **TYPES OF LIFE INSURANCE POLICIES**

The two original types of insurance are term insurance (insurance for a specified period of time) and permanent/whole life insurance (insurance coverage guaranteed for the duration of your life). Both products are used in planning; and depending on your situation, one may work better than the other.

#### **TERM LIFE INSURANCE**

Term life insurance is thought of as a simple product. It obviously has to be if people are purchasing it in droves on the Internet and from television commercials, right? While most people think of term life as simple, it is not as simple as it seems due to some important factors that many times should not be overlooked.

A simple explanation of term insurance is that you pay a set insurance premium for a certain period of time (the term); if you pass away during that term, the beneficiaries receive the death benefit. If you do not die during the term, with most policies, there is no refund of premium.

### **Guaranteed Level Term (GLT)**

This is the most commonly used term life insurance today. Guaranteed Level Term has a scheduled (set) premium for the complete term, which is set at the beginning of the contract. Generally, the terms are 5, 10, 15, 20, or 30 years. At the end of the term, you do not receive a return or refund of any premiums paid and are left with no insurance coverage.\*

\*The most important aspect of term policy is the **ability to convert** it at the end of the term to a permanent policy. Why? If an insured gets near the end of the term and then becomes terminally ill, it is vitally important to be able to **extend the coverage** past the end of the term. The cost after conversion will be the one-year annually renewable term cost. That cost will be expensive, but it's well worth it when an insured is diagnosed as terminal.

### **Annually Renewable Term (ART)**

Annually Renewable Term is not commonly used anymore despite its extremely low cost. ART is the least expensive type of a new life insurance policy you can purchase in any given year.

The problem with ART is that the policy renews (re-prices) itself every year. While you do NOT have to go through underwriting to keep the policy for the period purchased, from an economic standpoint, it is like you are buying a new policy every year. The older you get, the more the policy costs. At some point, an ART policy will cross over and cost more each year than a Guaranteed Level Premium policy. The crossover point will vary depending on your age.

As a general statement, GLT is always a better option for those who believe they will keep the life policy for the contract term. ART is usually purchased by people who have very little money and need insurance. They also usually hope that in the near future they will have more money so they can buy a GLT policy so they can afford to keep it for the entire term.

### **Return of Premium Term (ROPT)**

The majority of people under the age of 60 have purchased term life insurance at one time or another. Usually people purchase 10-30-year level term insurance because it is the most inexpensive way to fund a death benefit without increasing costs for a specific period of time.

While most people purchase level term life insurance, they also despise the concept of term life because they do not believe death will occur during the term of coverage. Therefore, they view the premiums, at the end of the period, were a total waste (although the insured did have peace of mind while insured).

A few select companies have come out with Return of Premium Term Life Insurance (ROPT). ROPT is very simple to understand. You pay a premium that is marginally higher than the normal level term life costs; and, if you do not die, you get the premium returned to you in full. The rub is that the insured does not get investment growth on the difference in premium paid between regular term (which is lower) and ROPT. Depending on the numbers, ROPT can work out well financially if you keep it for the full term.

### **Policy Riders**

Life insurance policies can come with a number of different riders if the insured is willing to pay for them. These vary from product to product and from carrier to carrier. These are the most common:

-Waiver of Premium. This rider will waive all premium payments during a period of disability, after a stated waiting period. This rider is very important and can make sure a supplemental retirement plan will self complete if a disability does happen.

-Guarantee Purchase Option. This rider allows the insured to purchase a stated amount of coverage at a future date without proving insurability. This could become extremely important in the event an insured becomes seriously ill.

-Long-Term Care Rider. This rider is very attractive. It allows the insured to purchase coverage that will help cover the cost of a nursing home or assisted living facility in the event the insured needs long-term care. These costs can be crippling and financially devastating without some form of coverage.

### **CONCLUSION ON TERM LIFE**

Statistics show that over 97% of the term life policies sold do NOT pay a death benefit. What does that mean? It means that 97% of the people who purchased term life insurance will feel like they wasted the premium due to the fact that they didn't die (although they are usually happy they didn't die).

Generally speaking, most people who have wealth, or want to, or expect to have wealth, do have a need for "permanent" insurance (either for tax-favorable wealth-building and/or for the death benefit). If that is the case, then buying term life insurance is NOT a good idea except to cover a short-term need.

### **THINGS YOU NEED TO KNOW BEFORE LEARNING/DISCUSSING CASH VALUE LIFE (CVL) INSURANCE POLICIES**

A "cash value" policy is a whole life, universal life, or variable life insurance policy. In short, an insured pays a planned premium; and some portion of the premium will go towards the "cash value." The premium allocated to the cash account value of the policy earns interest either at an annually declared rate or a rate that fluctuates due to stock market returns such as those in variable life policies or in indexed universal life policies.

#### **1) Cash Surrender Value (CSV)**

The CSV of a policy is the amount of cash you would receive if you decide to give up or terminate the life policy. The CSV in the early years of a life policy (typically years 1-10 and sometimes up to year 15) is always less than the cash account value (CAV). **A good rule of thumb is that the CSV will equal the cash account value (CAV) in year 10.\***

\*This is the rule of thumb. There are policies in the marketplace that have high cash value in the early years. I'm not generally a fan of high cash value policies because there is an additional cost to have high cash value early. I only recommend high cash value policies in leveraged situations (where borrowed funds are used to pay the premium) or when a client wants to hedge against

something going wrong in the few years after the policy is purchased (like losing a job, becoming disabled, etc.).

The CSV is lower in the early years to make sure the insurance company stays profitable in case an insured chooses to surrender the policy. The difference between the CSV and cash account value comes from the fact that the insurance company has underwriting expenses, has to pay commissions to insurance agents, and has taxes to pay.

## 2) **Cash Account Value (CAV)**

The CAV in a life policy is the amount of money the company actually allocates to an insured's growth account. The cash account value is always higher than the cash surrender value in the early years of the policy. The insured **does not** have access to the entire cash account value until the "surrender" charges in the policy are gone.

The CAV is really what grows inside a non-term life policy. If there are investment returns inside the policy, they are credited to the CAV. Then the insurance company applies its scheduled surrender charge to the CAV to calculate the client's CSV. If an insured plans to keep the policy in place for more than 10 years, typically the surrender charge is not an issue.

## 3) **Policy Withdrawals**

A "withdrawal" of money from a cash value life insurance policy is the partial surrender of the policy. A policyowner will not have taxable income until withdrawals (including previous withdrawals and other tax-free distributions from the policy such as dividends) made from the cash reserves of a "flexible premium" policy (i.e., universal or adjustable life) exceed the policyowner's cost (accumulated premiums).

Until the policyowner has recovered his/her aggregate premium cost, he/she will generally be allowed to receive withdrawals tax free under what is known as the "cost-recovery-first" rule.

Side note: An insured's income tax liability is accelerated if a cash withdrawal/distribution occurs within 15 years of the policy's issue and the distribution is coupled with a reduction in the policy's contractual death benefits. In other words, a withdrawal within 15 years of policy issuance coupled with a drop in death benefits triggers taxable income.

## 4) **Cash in a properly designed policy grows tax free and can be removed tax free.**

Section 7702 of the Deficit Reduction Act of 1984 (DEFRA) and Technical and Miscellaneous Revenue Act of 1988 (TAMRA) (which deals with the Modified Endowment Contracts (MEC) rules).

One of the main reasons cash value life insurance is used as a wealth-building tool is because cash in the policy is allowed to grow tax free and be removed tax free.

To better understand the following discussion of the MEC rules, consider this question: What is the best investment in the world? The answer is one where money can grow tax free and be taken out tax free.

Assume you are a 45-year old male looking to reposition \$100,000 of cash somewhere. You could invest in the stock market or in mutual funds. If you do that, you will have to deal with capital gains taxes, dividend taxes, money-management fees and/or mutual fund expenses which will significantly hinder the ability of the money to grow annually.

What about repositioning money into a cash value life insurance policy?

What if you could pay a \$100,000 life insurance premium, receive a \$105,000 death benefit, and have \$99,000 cash growing in the life policy totally tax free?

What if after ten years the amount of cash in the life policy had grown to \$250,000, and you could access that cash income tax free? Would that be a good tool to grow wealth? The answer is absolutely yes; and in the “old days,” that’s just about what was happening in the insurance industry.

To counteract what was perceived as an abusive use of single-premium, limited pay, and universal life policies as short-term, tax-sheltered cash accumulation or savings vehicles, Congress passed legislation modifying Code **Section 7702**. This Code section provides the tax law definition of a life insurance contract; and the modification created Code Section 7702A, which defines a new class of insurance contracts called **modified endowment contracts** (MECs).

Without getting too into the weeds on Section 7702, I’ll give a brief overview and the practical outcome of the code section.

7702 implemented what the industry terms a “7-pay test.”

### **What is the 7-pay test?**

It’s a test based on the amount of premium paid into the policy over a seven-year rolling window and the amount of death benefit provided.

Essentially the 7-pay test forces consumers to buy a certain amount of death benefit in their life policy. If the death benefit is not high enough over the life of the policy, the consequence is simple. You are NOT able to remove money tax free from the policy.

When using life insurance as a retirement tool so you can borrow tax free from the policy, it’s imperative that you NOT violate the 7-pay test.

Practically speaking, how do you avoid violating the 7-pay test when you buy and fund a cash value life insurance policy?

The insurance companies have idiot proofed their illustration software so when an insurance agent runs an illustration, it will NOT allow them to illustrate the policy to violate the 7-pay test.

The ideal funding of a cash value life insurance policy for retirement planning is to fund it in an equal amount for at least seven years. Funding less means you bought too much death benefit and funding more means the policy will violate the 7-pay test.

### 5) Policy Loans

When an insured is sold a cash-building life policy, the sale, in large part, usually revolves around “loans” that can be taken from the policy “income tax free.” There are two types of loans available in most cash-building policies: 1) wash loans and 2) variable loans.

You will **pay NO income tax if you borrow cash value from your life insurance policy** (this assumes the policy stays in place until death).

This is sometimes confusing for the insured. Often you will hear advisors (including myself) talk about receiving tax-free income from a life insurance policy. That's not technically accurate as you now know. You do not receive “income” from your life insurance policy; instead, you access the cash via loans.

Generally, loans are treated as debts, not taxable distributions. This can give you virtually unlimited access to your cash value on a tax-advantaged basis. Also, these loans need **not be repaid** (the loan is repaid at death through a reduction in death benefit).

After a sizable amount of cash value has built up in a policy, it can be borrowed systematically to help supplement your retirement income. In most cases, you will never pay one cent of income tax on the gain.

The main circumstance you will need to guard against is taking too much cash out of your policy through loans. If you do that, you will run the risk of the policy not having enough cash left in it to pay the premiums for you until death.

Typically, cash value policies are funded over a specific period of time, 5-7-10-20 years. If the policy is “over-funded” at the MEC minimum death benefit, significant cash should grow in your policy. After your premium payment period, there is still an annual cost of insurance that is owed in the life policy. This cost is paid out of the cash value of the policy.

When an insured borrows cash from a life insurance policy, the policy **must stay in place until death** (otherwise the insured runs the risk of the loan becoming taxable). Greedy clients or owners who do not budget well can get into a situation where there is not enough cash in the policy in the later years (and after loans) to continue to pay the internal costs of the policy. If the policy does not stay in force until death, the insured will have to pay taxes on the loans received from the policy that exceed the premiums paid.

To guard against the policy lapsing and having a client risk their loans being taxable, newer life insurance policies in the marketplace have added a **free-policy rider** that kicks in when you borrow money over the age of 65-70 (insurance companies offer this rider at different ages). The rider, once activated, guarantees that your policy will **never lapse**; and, therefore, you will avoid any

potential that the policy will lapse due to a lack of cash to pay annual expenses in the policy.

### **MORE ON LIFE INSURANCE POLICY LOANS**

Many companies have created what are called “**wash loans**” to make borrowing from a life insurance policy more saleable. A few examples are really the best way to explain wash loans. Let's start with a non-wash loan example:

If an insured has \$200,000 of cash surrender value (CSV) in a life insurance policy, the insured could call the insurance company and request a “tax-free” loan from the policy. Let's say that loan is \$10,000.

The insurance company has to charge interest in the policy on the borrowed money. If the loan rate is 8% on the borrowed funds, then the insured's policy is charged 8% interest on the loan; and that must be paid every year.

The insured's cash in the policy is still growing, but at what rate? If the crediting rate on the cash in the life policy is only 6%, then there will be a shortfall on the interest owed; and the cash value in the policy will start to go backwards.

If the cash in the policy goes backwards for too long, the policy could eventually lapse (which could trigger a taxable event on the money previously borrowed from the policy). Also, to avoid a policy from lapsing, a policyholder can make new premium payments (which is something most insureds do not want to be forced to do in retirement when they planned on removing money from the policy tax free via loans).

What if the insured had a wash loan option in the policy? If the insured had a wash loan, the interest charged on the loan would equal the growth rate on the cash in the policy. With a wash loan, the cash in the policy will not have to be used to pay the interest on the loan. Instead, the returns on the cash value will pay the interest.

If the interest on the loan is 8%, the insurance company will credit 8% on the same amount of cash in the life policy so it is a neutral transaction from the insured's point of view. The life policy was charged 8% on the \$10,000 loan, but the life policy also earned 8% on \$10,000 in the policy to create a neutral position.

Some of the newer policies have what are called “**variable loans**.” I will discuss these powerful and much abused loans later in this chapter where I discuss equity indexed universal life insurance.

## **CASH VALUE LIFE INSURANCE**

### **WHOLE LIFE INSURANCE**

Whole Life (WL) insurance has almost become the forgotten child in the insurance industry.

WL is a form of cash value life. In the old days, a WL policy was considered the only “guaranteed” death benefit policy. By guaranteed, I mean that, if an insured paid the budgeted premium, the insurance company promised to pay the death benefit.

Explaining how cash values grow in a whole life insurance policy is somewhat difficult. Technically speaking, whole life insurance companies pay “dividends” to policyholders when the insurer's investments perform well. Unlike a dividend you would receive on a stock or mutual fund, a dividend paid on a life insurance policy is essentially a return of premium that an insured previously paid. The dividend is based on the profitability of the insurance company. So, if the insurance company that issued the WL policy did well with its investments and had a profitable year, the dividend would be high.

Dividends from the insurance company are payable into the policy which can either increase cash values or purchase Paid-Up Additions (additional insurance/death benefit coverage).

Part of the profitability of the company comes from charging clients for the premiums paid. Therefore, when your policy issues a dividend to grow the cash value account of a life insurance policy, it really is returning to you an overpayment on your annual premium.

WL policies generally speaking are the most expensive type of permanent insurance you can buy in the early years of the policy. Without getting too technical, WL policies have a more “levelized” cost structure.

For example, if you are 45 and buy a WL policy with a million-dollar death benefit, the actual cost of insurance would be X. When you reach age 55, the actual cost would be let's say X times 3; and when you are 70 years old, the costs are X times 10.

In a WL policy, the costs are not the annually renewable term costs (which rise each year) but again are more of an average over your life expectancy. That means in the early years the costs are higher but in the later years (especially when you get over the age of 70) the costs are lower than Universal Life or Variable Life. Because costs are higher in the early years, early cash accumulation is hindered in WL insurance policies.

Whole life is the most stable type of cash value life insurance you can purchase (assuming the company you are buying it from is stable).

As I go around the country giving my educational courses to advisors, I always have someone in the audience who is what I call a ‘Whole Lifer.’ I use this term because they spent their career selling WL and believe that clients who want to purchase a cash value life insurance policy should ONLY buy WL.

My view of WL is very simple. If you want a stable policy with minimum guarantees on the growth of the cash in your policy AND you understand that the returns are NOT going to come anywhere close to equity markets over the long term, then you should look at a WL policy.

With the advent of new universal life policies that have lower expense guaranteed death benefit riders, the need to buy a WL policy to guarantee a death benefit no longer exists.

If you were to ask me if I would use a WL policy to build wealth for retirement planning, the answer would be NO. Why? Because I think the equity markets will outperform what a WL policy will return over time. If that is my belief, I should be in the newer indexed universal life policies which have lower expenses and have other favorable features to them which makes them much more attractive policies for wealth building.

### **THE HYBRIDS**

The insurance industry, in order to stay on top with current trends, invented new product classes from the 1980s to the present day. Since the products essentially combine features from term and whole life insurance, I will call them hybrids

Let's review some of the hybrid products and determine which might be the best fit for certain circumstances. The hybrids are Fixed Universal Life Insurance, Variable Universal Life Insurance, and Indexed Universal Life Insurance.

### **FIXED UNIVERSAL LIFE**

Developed originally in the early 1980s, Universal Life (UL insurance) combines the low-cost protection of term insurance with a savings component invested in a tax-deferred account, the cash value of which may be available for a loan to the policyholder. Universal Life was created to provide more flexibility than whole life by allowing the holder to shift money between the insurance and savings components of the policy.

Additionally, the inner workings of the investment process are openly displayed to the holder, whereas details of whole life investments tend to be obscure and difficult for the policyholder to understand.

The premiums, which may be variable, are divided into insurance and savings. Therefore, the holder can adjust the proportions of the policy based on external conditions. If the savings are earning good returns, they can be invaded to pay the premiums instead of injecting more money into the policy through premiums. If the holder remains insurable, more of the premium can be applied to the insurance to increase the death benefit.

Unlike whole life, the cash value investments grow at a rate which varies monthly. There is usually a minimum rate of return with UL policies, which sometimes can be 3% or more depending on the bond environment, which is locked in upon policy issue date.

Usually, policies issued during long periods of high interest rates will carry a higher guaranteed rate than those issued during or after a protracted period of low interest rates. Changes to interest rates allow the holder to take advantage of rising interest rates. The danger is that falling interest rates may cause premiums to increase or even cause the policy to lapse if interest income in the policy can no longer pay a major portion of the insurance costs (this is not likely to happen in an over-funded, non-MEC policy which has much more cash than is needed to pay the costs of insurance).

For many years, fixed UL products did not have a “guaranteed” death benefit option. Basically, a UL’s death benefit stayed in place as long as the premium was paid and the crediting amount on the cash was reasonable. In recent years, UL products have been updated to allow riders that can **guarantee a death benefit** in a “paid-up” manner similar to the 10- and 20-pay policies of a whole life policy. In fact, some UL policies will allow a client to buy a guaranteed lifetime benefit with a single premium.

Universal Life insurance policies are generally restricted to safe, low-yielding investments; and the most common investments are purchased in the bond markets.

The question then becomes: Should you use a traditional UL policy for wealth building?

My answer is NO; I would not use a traditional UL policy for wealth building.

What is a traditional UL good for? As stated, it’s the cheapest way to buy a guaranteed death benefit; and that’s primarily how I recommend its use.

### **VARIABLE UNIVERSAL LIFE**

Variable Universal Life (VUL) is a combination of insurance products and mutual funds. Like its cousin, UL, VUL is very flexible, accumulates cash, and some newer products even offer riders that offer death benefit guarantees.

VUL was popular when the stock market was averaging returns in excess of 12% a year. I like to explain VUL policies by stating that a VUL is like investing money in a mutual fund except the mutual fund is housed inside a tax-free wrapper. Insureds who own VUL policies can avoid annual dividend and capital gains taxes associated with actively managed money in a typical brokerage account.

Honestly, everyone loved VUL policies until the stock market tanked in 2000. One of the major drawbacks with a VUL is that there is typically NO guarantee on the cash in your policy. Remember, the money is literally invested in mutual funds inside the policy. If those mutual funds lose nearly 50% of their value like many did from 2000-2002 and over 50% between the highs of 2007 to the lows of 2009, the cash in your policy will decrease by that amount and more.

Why more? Because in a life insurance policy you have additional loads that you do not have in a brokerage account. I call this the double whammy. Not only do you lose money in the market which decreases your cash value in the policy; but with a VUL, the costs of insurance increase every year.

Owning a VUL in an up market is great and in a down market is a disaster.

The question becomes: Would I recommend using a VUL to build wealth? Absolutely not.

Readers looking to earn 6-8+% returns in their life insurance policy with **no investment downside risk** should look at Indexed Universal Life policies.

### **INDEXED UNIVERSAL LIFE (IUL) INSURANCE**

As just stated, many owners of variable life policies have found out that cash values in a variable policy not only go up with the market but they fall with the market as well. This prompted the proliferation of a “new” universal life policy, the Indexed Universal Life insurance policy (IUL). An IUL policy is a UL policy that has an annual minimum return guarantee (with most policies the guarantee is zero) but still allows the cash value in the policy to grow at **market rates** every year if the stock market has positive returns.

The policies also **LOCK IN THE GAINS** every year which is very helpful in a volatile equity market.

#### **How are investment returns calculated in an IUL policy?**

The vast majority of IUL products peg the cash value growth in the policies to the Standard & Poor's 500 stock index (one of the best performing stock indexes).

When I first looked at indexed life products, I actually thought the insurance companies took an insured's money, applied X amount to the costs of the policy, and invested the remainder into the S&P 500 stock index. I thought that was a bit risky, but I figured insurance companies own half the world so they could afford it if they had a few bad years.

In fact, the insurance companies **DO NOT** invest premium dollars inside an insured's policy into the S&P 500 index. After X amount of the premium dollars are allocated to pay the costs in the policy, the remaining amount of money is used to purchase **income-producing bonds**. The insurance company then takes the income from the bonds and buys the most favorable **“options”** it can on the S&P 500 stock index.

Explaining “options” is not easy, but I'll do the best I can without boring you to tears. The best way to explain options is with an example.

Assume we are dealing with a \$100,000 investment. Assume you allocate \$90,000 to an S&P 500 mutual fund (also known as a spider or index fund).

Assume you allocate \$10,000 to purchase “options” on the S&P 500. Let's say with the \$10,000 you would be able to buy a **“\$100,000 option”** in the S&P 500.

If the S&P increased 10% in the first year, what would be your returns?

The \$90,000 you invested into an S&P 500 indexed fund would increase by \$9,000 to a value of \$99,000.

On your “option,” you would earn a 10% return on the \$100,000 position you purchased. This would return to you your option cost of \$10,000, plus \$10,000 which is the 10% return on the \$100,000 position.

Total assets at the beginning of the following year:

$$\$99,000 + \$20,000 = \$119,000.$$

In the real world, when you buy “options,” there are costs to the options; and I do not want to get into the exact structure in my discussion for this material. What I will tell you is that, because of the costs and the structure of the options purchased by life insurance companies, the option returns in an IUL policy are **capped**. By capped, I mean that, if the S&P 500 returns 25% in one year, you will not be earning 25% in your IUL policy.

**Caps** on IUL policies vary per company. Some companies have caps of 14% and some as low as 10%.

### **New Volatility Control Indexes (VCI)**

Some companies are rolling out unique/proprietary investment indexes to be used as an alternative to the S&P 500 index. These new VCIs are managed by firms like Morgan Stanley and other big investment firms. VCIs are “actively managed” strategies vs. the S&P 500 which is a passive buy strategy.

200% rate of return—at the time this material is being published, one insurance company offers a VCI index that credits 200% (double) of what the VCI returns. So, if the VCI returns 7%, the return credited on cash in the policy is 14% (with no cap on the returns).

Trying to fully explain how VCIs are designed and managed is outside the scope of this material. But they seem to be growing in popularity in the industry, and readers should make sure they are dealing with an advisor who knows all the viable IUL products in the marketplace and can help explain the pros and cons of each.

It should also be noted that the returns in the S&P 500 based IUL policies do not include the dividend income that would normally be paid to an indexed mutual fund.

### **DON'T FORGET THE GUARANTEES**

Talking about upside growth that is pegged to the best measuring stock index is great. However, what is equally as great is the fact that the policies have guarantees in them so your money does **NOT GO BACKWARDS** due to downturns in the S&P 500. Every year there is a positive investment return inside the IUL, the policy **locks in the gains**.

When you couple the locking/guarantee feature of IUL policies with the potential to earn returns that closely mirror the S&P 500 stock index, you really have, in my opinion, the “**best**” type of life insurance policy to grow cash for retirement planning.

I know the Whole Life policy advocates take issue with my stance and that's okay. Everyone is entitled to their opinion. We won't know which policy works the best for 10-20-30 years after one is purchased. At this point, all we can do is look at the numbers of past performance and make an informed opinion as to which life insurance policy will work best to grow wealth.

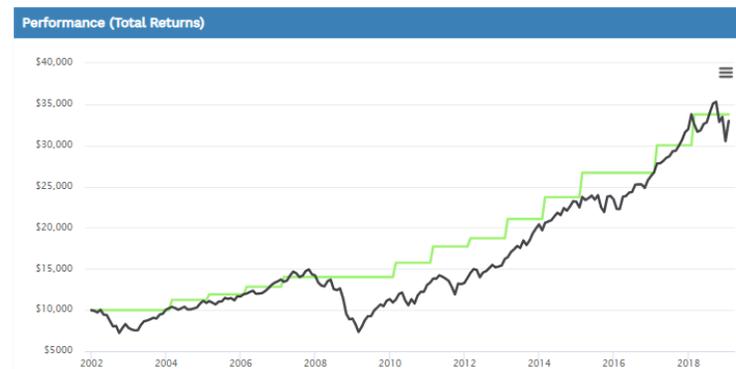
Here's an example to illustrate how an IUL policy can save a client significant money. I intentionally used 1999 as a starting point to show you how well an IUL policy works when the market goes negative. The following is from January 1999 to January 2009. The S&P 500 was negative 2.31%, and cash in an IUL with a 12.5% annual cap would have grown at 5.24%. The chart on the left is the performance and on the right is the maximum drawdown (zero for the IUL).

100% IUL 12.5% cap	<b>0</b> RISK SCORE	<b>-0%</b> MAX DRAWDOWN	<b>5.24%</b> AVG RETURN (CAGR)	<b>67.41%</b> TOTAL RETURN
SPY	<b>71</b> RISK SCORE	<b>-44.86%</b> MAX DRAWDOWN	<b>-2.31%</b> AVG RETURN (CAGR)	<b>-20.98%</b> TOTAL RETURN



Let's look at another example that includes the last two market crashes and a historic bull run in the stock market (2002-2018). You'd think that the S&P 500 would do much better than an IUL policy with a 12.5% cap, but it doesn't.

100% IUL 12.5% cap	<b>0</b> RISK SCORE	<b>-0%</b> MAX DRAWDOWN	<b>7.38%</b> AVG RETURN (CAGR)	<b>237.66%</b> TOTAL RETURN
SPY	<b>71</b> RISK SCORE	<b>-50.78%</b> MAX DRAWDOWN	<b>7.23%</b> AVG RETURN (CAGR)	<b>229.64%</b> TOTAL RETURN



As you can see on the chart, the S&P 500 was down over 50% while there are never any negative returns in an IUL. Also, the cash in the IUL grew at 7.38% vs. 7.23% for the S&P.

The previous two examples are not perfect because they don't take into account the expenses in the life policy or taxes and fees in a typical brokerage account. I will cover the real math of growing wealth in a brokerage account, tax-deferred IRAs/401ks, vs. an IUL in a separate section of the course.

But for this section of the material, I'm simply trying to explain the protective wealth-building features (annual locking of gains) of an IUL which I think come through pretty clear in the previous two charts.

### **“FREE” (NO-COST) LONG-TERM CARE BENEFITS**

One of the expenses more than 50% of Americans can look forward to paying for is the cost of long-term care (LTC).

Many Americans are tuned into the costs associated with LTC because a loved one (parent or grandparent usually) has had to pay for LTC costs.

If many Americans are tuned into this cost and if the statistics state that more than 50% of Americans will need LTC at some point in their lives, then it must be the case that the majority of Americans are buying LTC insurance to protect against this cost. Right?

Wrong. Traditional LTC insurance is very expensive, and the vast majority of Americans do not have it (even though many know they need it).

One of the unique features of my favorite IUL policy is a free LTC benefit. How can any insurance company afford to give an insured a free LTC benefit? It's actually not that hard to understand.

The insurance company is simply going to pay the insured part of the death benefit from the policy early to pay for LTC expenses (it's a tax-free benefit as well). The company is going to have to pay a death benefit when an insured dies; so instead of waiting, the company makes a portion of the death benefit available when the insured needs it.

The insurance company lowers the death benefit to take into account payments or LTC expenses.

Most people do not think of buying a life insurance policy for the “living benefits,” but being able to receive a FREE LTC benefit is truly revolutionary and gives IUL policies a leg up on other types of cash value life insurance policies.

The primary FREE benefit that is offered is technically called a chronic-illness rider. It typically kicks in when an insured can't perform two of their six ADLs (Activities of Daily Living) without assistance. Those six ADLs are eating, bathing, getting dressed, toileting, transferring (being able to either walk or move oneself from a bed to a wheelchair and back again), and continence (the ability to control one's bladder and bowel functions).

## PROS AND CONS OF BUILDING WEALTH IN AN IUL POLICY

### Cons –

1) If the stock market averages much more than the cap rates for the time the insured has the IUL policy, the insured would be better off with a variable policy (not very likely).

2) If the stock market averages less than 5-6% in annual returns over the time, the insured may be better off with a conservative Whole Life policy (mathematically this is very unlikely and to hedge this an insured can use an IUL with a VCI that credits 200% of the index).

### Pros –

1) Your cash is allowed to grow income tax free.

2) Cash can be removed tax free.

3) Gains are locked in annually.

4) Gains can never be lost due to a stock market downturn.

5) Flexibility. Unlike typical Whole Life policies, the IUL policies are very flexible so the owner can choose when and how much premium is to be paid each year.

6) A free LTC benefit (living benefits).

## VARIABLE LOAN OPTION IN IUL POLICIES

As I discussed previously in this chapter, after you build wealth/cash in a life insurance policy, the preferred way to remove the cash for use in retirement is through a policy loan (also referred to as tax-free retirement income).

While everyone in the industry thought “wash loans” were revolutionary as a way to allow clients to more conservatively pull larger amounts of cash out of their policies, when the new variable loans feature came out, that really excited those in the insurance industry.

As a side note, I did want to point out that some in the industry call variable loans “participating” loans. The terms can be used interchangeably, and you’ll understand why the term participating makes sense from the explanation to follow.

As you’ll recall, if you borrow money from your life insurance policy, the insurance company will charge you interest on the loan which is due every year. If the policy has a wash loan feature, the crediting rate on the cash in your policy will mirror the interest rate on the money borrowed from the life insurance company; and it’s a wash/neutral transaction for the insured.

The most important thing to understand with variable loans is that the borrowed funds come from the general account of the insurance company NOT from the insured’s policy.

Why would an insurance company give an insured money from the general account instead of taking it from their own policy?

It's done to create a design in an IUL that mathematically should allow insureds to borrow significantly more from their policies than using traditional wash loans.

One question that needs to be answered is what's the interest rate on the loan? When variable loans were first introduced, the lending rate on borrowed funds mirrored the Moody's Corporate Bond Index. In a low interest rate environment, that can be as low as 2% or can exceed 10% in a high rate environment.

In most IUL policies today, the companies have a fixed lending rate on their variable loans. These rates are locked for the life of the policy. Some companies offer a 5% rate, some 5.3%, and some are set up not to exceed 6%.

An example is the best way to understand logistically how variable loans in IUL policies work.

Assume you've owned the policy for a number of years and have \$250,000 cash in the policy. You want to take a \$25,000 loan using the variable loan option. What happens?

- 1) The insurance company loans you money from their general account.
- 2) The loan rate is 5% on the borrowed funds.
- 3) The entire \$250,000 in cash is still in your IUL, and it will grow at whatever the measuring stock market index returns.

If we assume the measuring index returned 12%, that return is applied to the entire \$250,000 of cash in the policy (yielding a \$30,000 gain).

The return on \$25,000 of the \$250,000 that we can mentally earmark as the borrowed funds grows at 12%.

However, the interest charge on that \$25,000 in borrowed funds is only 5%.

That means there is a positive loan arbitrage of 7% (12%-5% = 7%) on the \$25,000 of borrowed funds.

In other words, you made money (\$1,750) on the borrowed funds.

That sounds great. But in a year when the measuring stock market is negative, there is a zero credited toward growth (no negative returns in an IUL). In this example, you are charged 5% interest on the \$25,000 loan. That creates a 5% negative loan arbitrage (-5%); and in that year, your cash value will go backwards due to the interest charged.

The million-dollar question is does it make sense to use variable loans?

To me, it's a probability question that is pretty easy to answer. If the average rate of return in an IUL policy with a 12.5% cap is 7.38% going back to 2002 (which includes two big market crashes and a nice bull run in the stock market) and if I have a policy that has a fixed lending rate of 5% in the policy, it's a no brainer to use variable loan to create tax-free cash flow from my policy instead of wash loans.

Let's now look at a **more full-blown example** showing the difference between wash loans and variable loans.

Assume in my example that the client is male, 45 years old and in good health. Assume he will fund \$15,000 a year into an IUL policy for each year until he turns 65 and then will borrow "tax free" from his policy from ages 66-90. Assume the average S&P 500 returns over the life of the policy are 6.9%.

How much could he remove from his policy with wash loans and how much from a variable loan where the policy has a 5% guaranteed loan rate?

If the policy used to illustrate this example used wash loans, the client could borrow \$48,590 "tax free" from the policy every year from ages 66-85.

If the policy credited the same average 6.9% rate of return on the cash value AND the variable loan interest rate is fixed at 5%, the client could borrow \$60,353 tax free from the same policy from ages 66-85.

The variable loan option generated \$11,763 more tax-free borrowing from the policy each year or \$352,890 more over the 30-year borrowing phase.

### **Further Protection**

I alluded to an IUL policy which credits 200% (double) of what a volatility control index returns. This type of index crediting method can further protect an insured in the borrowing phase.

Think about it, if in any given year you had a return of 3% in the policy, if you used the policy with a 200% crediting method, the credited return would be 6% (3% x 200%). If the loan rate on the variable loan was 5%, you would go from a negative 2% loan arbitrage to a 1% positive loan arbitrage.

This type of crediting method can provide more security for those who are worried about the variability of a variable loan.

### **Summary on variable loans**

Variable loans are a good option to have in a policy (one that is not available in whole life policies). With most IUL policies, when you borrow using a variable loan option, you can choose each year to borrow using the variable loan or the fixed wash loan option. The more options, the better. Also, if you want to protect yourself in the borrowing phase, you should consider using the policy with a maximum lending rate of 5% and/or one that credits more than 100% of the measuring stock index (like the one that credits 200% of a proprietary volatility control index)

### **Conclusion on IUL insurance policies**

If you like the possibility of earning upwards of a 10-16% return on the cash value in your life insurance policy in any given year, would like to allow your cash to grow tax free and be removed tax free, would like to avoid the stock market's negative years with gains being locked in after down years, then you are a candidate to use IUL for wealth building.

## **HOW TO PROPERLY ILLUSTRATE CASH VALUE LIFE (CVL) FOR RETIREMENT PLANNING**

If you can't tell by the title of this section, there is a right and a wrong way for an insurance agent to illustrate a CVL policy.

What you will read in this section of the material sadly isn't known or understood by a significant percentage of insurance agents who sell CVL.

Based on what you've read so far if asked the question, how much death benefit should you purchase when buying a CVL policy where the goal is maximum cash and tax-free borrowing, what would you say?

You should say the answer is the minimum allowable death benefit allowed by the 7-pay test (MEC test).

What about your overall life insurance needs which haven't been discussed too much in this chapter?

You might need \$1 million of coverage to protect a spouse, children, or other loved one.

Does that mean when you decide to pay a \$10,000 premium into an IUL to build wealth for retirement, you should buy it with a \$1 million dollar death benefit?

**NO!**

When buying CVL, you want to always buy the minimum death benefit. To do otherwise creates higher expenses that will eat away at your cash value.

But what if you really need \$1 million in coverage and with your \$10,000 annual premium the 7-pay test minimum death benefit is only \$750,000?

You have two options:

1) Buy \$250,000 in term insurance (could be 10, 20, or 30-year level term). With your CVL policy, as time goes, on the cash will grow and the death benefit will increase and, in this example, will go over \$1 million in coverage well before you reach the end of a 20- or 30-year term.

2) Most CVL policies allow you to add a term rider to the policy. So, you could add a cheap \$250,000 term rider onto the CVL policy. I don't like this option as much because most CVL companies are not the cheapest when it comes to the cost of pure death benefit coverage.

### **Increasing death benefit vs. Level death benefit**

You also need to be familiar with the concept of an increasing vs. a level death benefit in a life illustration.

A significant portion of life agents selling CVL default to using a level death benefit illustration.

It's simply an input on the life insurance illustration software an agent can use to tell the system to use increasing or level.

This issue is different than the previous one about buying term insurance to cover the death benefit shortfall.

An insurance agent can choose to run an illustration at the 7-pay test minimum death benefit with a level or increasing death benefit.

But the outcome for the client buying the policy is dramatically different.

The best way to explain this is with an example. Let's use the same 45 year old who is going to pay a \$15,000 premium into an IUL for 20 years and then is going to borrow tax free a level amount each year from the policy from ages 66-90.

**Illustration #1**—**level** death benefit from day one.

The initial death benefit = \$941,362

The amount that can be borrowed tax free from ages 66-90 = \$48,179

**Illustration #2**—**increasing** death benefit the first 20 years (the payment period) and level death benefit years 21 through age 100.

The initial death benefit = \$362,533

The amount that can be borrowed tax free from ages 66-90 = \$60,353

The difference in borrowing each year is \$12,356 (more using increasing).

The difference over the 30-year borrowing phase is \$370,680.

The difference is huge, and this is why I recommend using an increasing death benefit. You start with a lower initial death benefit and can buy term insurance to fulfill your short-term life insurance need.

In this example, if we assumed the client needs \$1 million in death benefit, the level death benefit illustration got the client close to that number.

But at what cost? \$12,356 a year in borrowing each year for 30 years?

Just as an FYI, a \$650,000 death benefit/20-year term life insurance policy for a healthy 45 year old male only costs approximately \$775 a year.

It's no brainer to buy the CVL with an increasing death benefit and to fill the other life insurance need with a 20-year term. Why did I use 20-year term? Because as budgeted, the CVL policy will have approximately \$1 million in cash in it at age 65 when the term policy would expire.

Why then would an insurance agent recommend or use level death benefit when selling a cash value life policy to a client?

Commissions!

The commission for the level death benefit illustration is nearly three times larger than the increasing death benefit illustration.

For clients who don't know any better, the level death benefit illustration showing borrowing of \$48,179 each year looks pretty good. But it's not nearly as good as what could be expected with an increasing death benefit policy.

This is why I wrote my book *Bad Advisors: How to Identify Them; How to Avoid Them* and why I put a section in this course on bad advisors.

### **NEEDS ANALYSIS**

I'd like to conclude this section of the material on what many insurance agents call a needs analysis. What's that? It's simply an analysis to determine how much life insurance (death benefit) you need.

Depending on what kind of insurance agent you work with, you will get a different answer to the question.

My answer is always the same, as little as possible to accomplish the goal at hand.

Many insurance agents are looking for excuses for clients to buy as much as possible so they can make the biggest commission.

I'm not going to get into the many different ways to calculate the need. Most people are smart enough to figure it out without the help of an agent or needs analysis.

If you died today, if you died next year, if you died five years from now or 10 or 20, what kind of death benefit would be needed to accomplish your goals?

Those goals could be paying off a debt or amassing enough cash for a loved one so he/she didn't have to work for 5, 10, 20 years or more. The goals could include paying for a child's college education.

When looking at the lump sum death benefit that will be paid, you have to make certain assumptions about how that death benefit will be invested and spent.

I'll give a few simple examples. Let's use the 45-year-old male but let's assume he's married to a spouse (also age 45) who works and they have two children. For argument's sake, let's say the spouse makes \$60,000 a year; and the husband makes \$50,000 a year.

#### **Who needs life insurance and why?**

Does each spouse need life insurance to take care of the other one in the event of death? That's a tough question. An insurance agent would typically want to have each spouse buy approximately the same amount of life insurance. Why? To pay off debt (assume they have a \$400,000 mortgage) and to pay for the children's' college education.

The typical sales pitch is also that, when one spouse dies, the other will want to take a significant amount of time off from work and a large death benefit will allow for that to happen.

The reality is that, if one spouse dies, the other spouse isn't going to all of a sudden be a stay-at-home mom or dad. They will have a period of mourning but then will go back to work.

### **What would I recommend in this situation?**

I'd need more information because, if they had the cash flow, I'd most likely recommend that one of them buy an IUL policy so money could grow tax free, without risk, where gains are locked in every year, and where money could be borrowed tax free in retirement.

But as far as a pure death benefit, I'd probably recommend term insurance of some amount on both of them with a 20 or 30-year guaranteed level term. That amount would be used to pay off the mortgage on the house and fund the children's college education.

I typically don't recommend people gratuitously buy sizeable amounts of life insurance so that in the event of death the surviving spouse gets a windfall.

As I stated earlier, 97% of all term life policies never pay a death benefit (so why waste the money on an excessive death benefit).

Let's tweak the example a little and assume one of the spouses is a stay-at-home parent and does not plan to work while the children are growing up and maybe never really plans to work. To figure out the needed death benefit, you have to get your calculator out. The death benefit will need to be big enough so, that when money from the policy is invested, there will be enough money to pay for expenses for a number of years.

If a \$1 million policy was purchased and the spouse died the year the policy was purchased, what would that do? If you assumed that the money was invested and assumed a 6% annual withdrawal rate (\$60,000), how long would that money last?

The answer depends on how the money was invested. If the \$1 million policy generated a return of 4%, the account would go to zero when the living spouse reached age 76.

What if the money was invested in something too risky and it went through a 25% downturn in the market in the 2<sup>nd</sup> year? Then, at that withdrawal rate, the money would be all gone at age 62.

The point being that it's not an exact science when trying to figure out how much death benefit to purchase. Just use your common sense; and if you work with an agent who has professional ethics and the ability to run simple math calculations, you should be able to come up with an amount you feel comfortable with.

### **2<sup>nd</sup> to die**

I did want to mention that, if a couple is looking to pass on a death benefit at the 2<sup>nd</sup> spouse's death, the cheapest way to do so is through a 2<sup>nd</sup>-to-die policy. When an insurance company underwrites for the death of two people, it extends the time for when the company will have to ultimately pay; and, therefore, the costs are much less expensive. In my last examples, a 2<sup>nd</sup> to die wouldn't make any sense unless the only goal of the life insurance was to take care of the children in the event both parents died before they completed college.

My point with this section of the material is to say don't be afraid to think critically about the amount of life insurance you need to purchase. Don't just blindly follow an insurance agent's needs analysis. Invariably, the one I've seen done typically recommends a death benefit that is far in excess of what I typically would recommend.

### **CONCLUSION ON LIFE INSURANCE**

To say that life insurance is a misunderstood tool when it comes to wealth building would be a dramatic understatement. When insureds do not understand how and why a wealth-building tool works, how can they be expected to embrace its use as part of a main tool in their overall financial/retirement plan?

While this material will not make you a life insurance expert, I hope you have learned several things you didn't know before you read it. I hope now you know the differences between term, whole, universal, variable, and indexed universal life insurance.

I hope you understand the tax-free aspects of building wealth in life insurance policies which are designed as over-funded, non-MEC policies.

Since I believe IUL is the best type of cash-building policy, I spent quite a bit of time explaining how the policy works to protect your cash from downturns in the stock market while providing you good upside potential in the equity market (the S&P 500).

If you understand how variable loans work with IUL, I can guarantee you that you know more about the product than half of the agents selling it.

While many readers think that anyone can get a life insurance license and, therefore, anyone can give good advice about life insurance policies, you now know that there are many variables and nuances to life insurance policies that must be known in order to give the best advice to clients.

With the information learned in this material, you should be able to have a meaningful discussion with a life insurance agent about the best type of life insurance that is best for you.

Now that you should have a good working knowledge about CVL insurance; you can move onto the next section of the course which will cover how CVL insurance compares as a wealth-building tool to funding stocks, mutual funds after tax in a brokerage account, or building wealth through tax-deferred IRAs/401(k) plans and Roth IRAs/401(k) plans.