FA Financial Alternatives
integrated wealth management

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Introduction

As most of you know our April and October quarterly newsletters focus on financial planning topics and our January and July newsletters focus on investment topics. Our goal with this quarter's planning newsletter, is to help you better understand life insurance. Life insurance itself is quite simple, but it was made complicated by an industry that profits from this complexity. Proper life insurance planning is essential to creating a sound financial plan for you and your family.

The Purpose of Life Insurance

The main purpose of life insurance is to quickly replace lost income for your dependents should you die prematurely. It should not really be called life insurance because your life cannot be insured - you cannot be fixed or replaced like a car or house. Instead, life insurance should be called "income replacement protection for dependents". If you die with life insurance, the proceeds can be used in many ways, but one of the most important is to provide cash to the people that rely on your income.

Once you have accumulated a large enough estate to care for a spouse, partner, and young children, or you no longer have dependents, this need goes away.

A typical family with young children and a small estate has a large need for life insurance. As years pass, the kids grow up and become independent, and the size of their estate grows, and the need for income replacement eventually declines to zero.

Other purposes for life insurance include providing funds to inheritors or others to pay anticipated estate taxes, or to cover key people in order to keep a business running. These purposes are not the subject of this newsletter.

What Type of Life Insurance Should I Buy?

This is where it can start to get complicated and overwhelming because there are so many different types of life insurance products. There is term insurance which includes: Decreasing Term, Annual Renewable Term, and Level Term. There is also cash value life insurance which includes: Whole Life, Single Premium Whole Life, Universal Life, Indexed Universal Life, and Variable Universal Life. Is your head spinning yet?

Executive Summary

- Life Insurance is not complicated. It was made confusing by those that profit from this confusion.
- Every policy is either term insurance or term insurance attached to a savings/investment account.
- Insurance is for dying, investments are for living; don't combine the two.
- By combining insurance with investments, it is harder to get the cheapest insurance and optimal investment selections.
- If you have older policies, evaluate them closely before you decide to drop or replace them.
- Your Universal or Variable Life policy may not live up to its sale illustrations and could be in jeopardy of lapsing sooner than you expect.
- A policy that lapses with a loan against it could result in a large taxable event.
- Don't buy life insurance from someone whose sole business is to be a commissioned life insurance salesperson.
- It is better to get life insurance advice from a knowledgeable, experienced, fee-only Certified Financial Planner who is working in conjunction with an experienced, independent insurance broker.

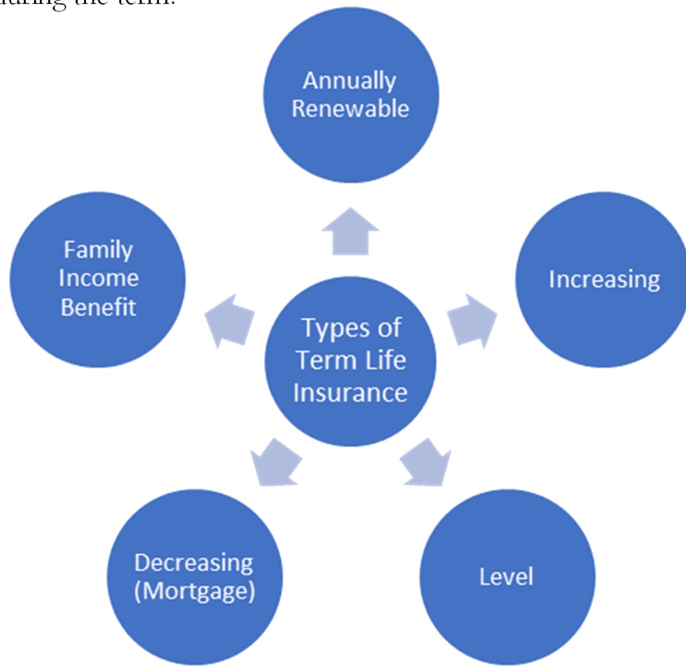
Term Life Insurance

To simplify things, remember there is really only one type of life insurance – term insurance. All other types of life insurance are simply term insurance plus a savings/investment account attached. So, term insurance is a component of every life insurance policy. With term insurance, you pay a certain premium (cost), and the insurance company pays your beneficiary an agreed upon amount of money if you die before the term ends. There is no savings account attached to term life insurance – if you as the insured person don't die during the term, your insurance beneficiaries get nothing back.

Naturally there are many different types of term insurance policies: some have a fixed premium and the insurance benefit drops each year (Decreasing Term), some

renew on an annual basis (Annual Renewable Term – ART) where the premium goes up each year, but the insurance benefit stays the same, and some have a level term period for 5, 10, 15, 20, 25, or 30 years (Level Term) where both the premium and the insurance benefit stay the same for the fixed period.

There are many different features that can be added on to term insurance that could change the premium and benefit amounts, eligibility, conversion rights and so forth, but fundamentally, there is a simple exchange of the cost of the insurance for the benefit payment if the insured person dies during the term.



Cash Value Life Insurance

Any type of cash value life insurance policy is nothing more than term insurance attached to a savings vehicle. It really is that simple. The problem is that when you combine term insurance with a savings vehicle it is difficult for the average person to evaluate how competitive the term policy rates are and to evaluate how good the savings vehicle is.

Insurance companies often refer to cash value life insurance as "Permanent" insurance. The truth is that this is a very misleading use of that word because these policies can fail for a variety of reasons. Misleading life insurance illustrations (projections) have become such a problem that regulators in New York issued a new rule to mitigate this abuse (Regulation 187 that went into effect in 2020).

By combining term insurance with a savings account, life insurance companies can charge higher rates on the term insurance component and higher fees and commissions on the savings/investment account component. Many companies and agents hide these additional costs and fees by showing their customers overly optimistic projections. It is usually best to keep your insurance and your investments separate. Remember this, "Insurance is for dying, investments are for living, don't combine the two".

It is not uncommon for insurance companies to keep 50% to 100% of the money that goes into the savings accounts in the first year and to have a surrender charge for up to 10 years for making an early withdrawal from the savings vehicle. No one would open a bank savings account or buy a mutual fund inside an IRA or 401k with these provisions, but many people do it with life insurance policies without really understanding the high cost.

The other option to access the savings account in a life insurance policy is to borrow the funds from the policy. The case is made that this is a way to access your funds without paying taxes. But in this case, you are paying to borrowing your own money!

The sales pitch on the savings vehicles attached to term insurance policies is they are tax deferred and in the later years you can borrow the funds out of the policy and never have to pay taxes on the earnings. After analyzing hundreds of these polices over the years, we have found that the problem is the cost of the term insurance and the fees attached to the saving accounts are so high that they eliminate the tax deferral benefits - especially in the early years of the policy.

We believe keeping your investments and your insurance separate is a superior way of covering your insurance needs as well as planning for your investment needs. This way you can easily shop for the most competitively priced term insurance and then invest your money into very low-cost investment vehicles outside of insurance policies such as IRAs, Roth IRAs, 401ks and deferred compensation plans. In addition, for many families, buying competitively priced term

insurance is the only way to afford the amount of insurance they need.

Whether you buy term or cash value life insurance, the goal in either case is to build up your assets so that you have an estate that can generate an income for you and your family while you are alive - not after you die.

Recent Life Insurance Review

Client Situation

When this couple came to us, they were in their mid-thirties, their child was five years old, and they had the following life insurance policies:

1. An annual renewable term (ART) policy on the husband with a death benefit of $656,494 and a rising annual premium which was $813 in the current year and scheduled to rise to $3,908 in year 20, resulting in a 20-year cost of $38,526.
2. An adjustable life cash value policy on the husband with a death benefit of $693,494, a current premium of $7,717, a current cash value of $46,321 and an outstanding loan of $41,542, they had been paying over $12,000 a year into this policy but had reduced their payments to $7,717.
3. A $200,000 group insurance policy through the husband's work.
4. A $1,950,000 ART term insurance policy on the wife.

Our Analysis

After doing a thorough life insurance needs analysis, we concluded that the husband should carry roughly $3,500,000 to $4,000,000 in coverage and the wife should carry roughly $1,000,000. We then shopped for an inexpensive term policy and further evaluated their current policies through an independent insurance broker. We were pleasantly surprised to find that the husband qualified for the best preferred rate and he was able to get a $3,500,000 level term policy for just $1,466 a year fixed for 20 years.

When compared to his existing term insurance pricing he would have paid over $38,000 for just $656,506 of coverage over 20 years and now he is set to pay less than $30,000 over 20 years for more than five times as much coverage!

After analyzing the adjustable life policy, we determined that the guaranteed interest rate on the cash values over 20 years was essentially 0% and the projected rate was less than 4%.

The Results

They decided to surrender the cash value policy and instead to redirect the money that they were putting in this policy into a "back door Roth IRA" (to accumulate funds on a tax-free basis) and into a self-employed 401k that the wife was eligible to set up.

The taxes saved each year by making contributions into the 401k are more than enough to pay their annual term insurance premiums each year for the next 20 years, resulting in a much more tax efficient use of their hard earned dollars.

Also, by surrendering the cash value policy, their loan disappeared since they were in effect borrowing their own money. And since the policy was relatively new, there was no taxable gain incurred by surrendering the policy - the value of the policy was less than the premiums that they had paid in.

Due to a heath condition, we were not able to find a new term insurance policy for the wife that was substantially cheaper than her current policy. As stated earlier, our analysis showed that a $1,000,000 policy on the wife was sufficient. However, since the premiums were currently low on her existing policy ($1,950,000 ART term insurance), we and the independent broker advised them to keep the higher amount for the time being. They decided to keep the higher insurance amount at least while their child is young, knowing that they can always reduce the amount of insurance to keep their costs under control as the premiums increase over the years.

The Bottom Line

In summary, when this family came to us, they were underinsured, not earning a competitive rate of return on their cash values, not maximizing their before-tax retirement contributions, and not taking advantage of tax-free Roth IRA opportunities.

Now the husband's insurance benefit level has increased from about $1,550,000 to $3,700,000, at a lower cost over the next 20 years than what they were paying for $656,494 of term insurance. In 20 years, their child will be grown and the need to provide for their child should be over. More importantly, they are likely to have a larger and better positioned asset base than if they continued to invest inside of their current cash value life insurance policy.

Should anything happen to the husband's health that would cause him to want to keep his term policy longer than the 20-year period, he can convert it to a cash value policy, or health permitting, he can buy another term insurance policy for whatever term period he needs.

Working together with their broker, we have worked with clients to convert their term polices to whole life policies due to health conditions that could lead to a shortened life expectancy – sometimes even though they did not need the life insurance anymore. Instead, these recommendations made sense from a pure investment point of view.

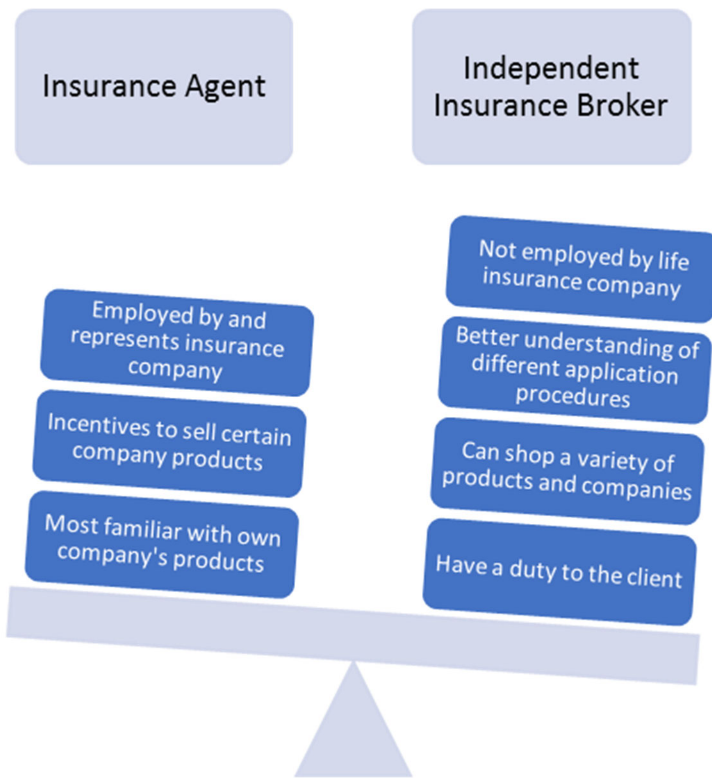
How (Not) To Buy Life Insurance

The main takeaway from the above story is to never buy life insurance from a commissioned life insurance salesperson. They may have good intentions at heart, but their companies pay them dramatically more money to sell expensive cash value life insurance rather than inexpensive term life insurance. These more expensive policies are significantly more profitable to the life insurance company - and remember, this profit is coming straight out of your pocket.

However, you often cannot shop for, and buy life insurance without an agent earning a commission, meaning

that the person must be licensed in order to sell you the policy. So, what do you do?

It is better to get life insurance advice from a knowledgeable, experienced, fee-only Certified Financial Planner who is working in conjunction with an experienced independent insurance broker. Get the advice as to what policy to buy from independent, objective people who have nothing to gain from you buying one policy over the other – insurance brokers do not have an employment arrangement with an insurance company, unlike insurance agents. This is a winning combination when it comes to designing and implementing an effective and adequate life insurance plan.



What Should You Do Now If You Have Paid into Existing Whole Life, Universal Life or Variable Life Insurance Policies for Years?

After reading up to this point, you would probably expect us to say that you should get rid of old cash value life insurance policies - but this might not be the case. First, you should of course evaluate your need for life insurance, and with that consideration it's critical to uncover how your existing policies are doing.

Significant Cash Value

New clients sometimes come to us with old policies they have been paying into for years which have accumulated savings (cash value). Often in these cases their heirs would not need the very small amount of insurance on top of the existing cash values in their policies.

What we often focus on in these cases is the internal rate of return on the cash value of the policy. This can be calculated by looking at the growth of the cash value over the prior years as well as reviewing in-force illustrations - which project the cash value and the dividends of the policies into the future.

If the cash value returns are in the 2% to 4% range, we may advise clients to keep the policies and view them as a conservative fixed-income investment (assuming this complements their other investment accounts). With current interest rates as low as they are, a return of 2% to 4% is competitive for a relatively conservative fixed-income investment.

Possible Lapse in Coverage

Often what we see with older Universal Life Policies or Variable Universal Life polices is that they are underfunded and at risk of lapsing if additional cash is not added to the policy. This is because interest rates have been much lower than the rates used in the sales illustrations when the policies were originally sold.

In such cases, it is important to request an in-force illustration and determine how much money, if any, needs to be added to keep the life insurance in effect. An analysis also needs to be done to determine the current insurance need if any. These types of policies can unexpectedly lapse and leave the client with no insurance and no cash value - despite being told the policy would last their entire lifetime and accumulate a significant amount of cash value for their future retirement.

What to Do If You Have A Large Loan Against an Old Policy?

If you have an insurance policy with a loan amount larger than what you invested into it, and you let it lapse, you will incur taxable income on the difference between the loan amount and the amount you invested into the policy.

Nearly a decade ago, we began working with a couple that had a Variable Universal life policy. They bought the policy in 1986 and invested a lump sum of $50,000 into it. At some point they took a loan on this policy and by the time they got to us, the loan balance had grown to $133,000. The policy had a cash value of $23,765 and a death benefit of $46,498.

The client had no intention of ever paying this loan off. We let them know that in order to avoid a large taxable gain, they needed to make sure there was always enough money in the policy to pay the internal term insurance costs and keep the policy in force. Ever since then we have helped to watch the policy to make sure there is ample cash value in the policy. Fortunately, the cash value was invested in a balanced fund during a period of good stock performance which has helped the cash value last longer, but we still had to advise them to add

funds to the policy several times over the years. The loan amount has since grown to over $183,000 so it is even more important now not to let it lapse.

You really need to understand how these policies work, and coordinate with professionals to help decide whether you want to keep the policy in force or not. In some cases - like the one described above - you may not have much of a choice! By all means, be sure to avoid the ugly tax surprise that you'll face if you let a policy with a large loan lapse.

If you have any old policies lying around that you would like to review, let us know and we will be happy to work with you and your insurance representative to analyze them for you.

Summary

Life insurance is not that complicated when you understand that every policy is some form of term insurance by itself or some form of term insurance with an added savings/investment account attached to it.

Remember this, "Insurance is for dying, investments are for living, don't combine the two". We recommend keeping your insurance and your investments separate so you can focus on getting the best deal on both. Combining them is often in the best interest of the life insurance company but not your best interest.

If you have older policies, assess the rate of return on the cash value and determine your need for life insurance. You may decide to keep these policies as part of your conservative fixed-income portfolio, or you may decide to modify or replace them.

If you have Universal or Variable Universal life insurance policies, have a thorough analysis done to determine when the policies will lapse if additional premiums are not added. Also, be sure you are not facing the possibility of a large taxable gain if you let a policy lapse with an outstanding loan against it.

And most importantly it is better to get life insurance advice from a knowable, experienced, fee-only Certified Financial Planner who is working in conjunction with an experienced independent insurance broker.

We hope you and your family are well. Please contact us if you would like to discuss any aspect of your financial life in greater detail.

Past performance is no guarantee of future results. All content in this newsletter is intended as general information, not specific advice. Performance data listed is for illustrative purposes only. Portfolios are personalized and often consider many variables, including investment objectives, age, time horizon, risk tolerance, and tax variables. Information contained herein has been obtained from sources believed reliable, but not guaranteed.

Permission was obtained from the clients discussed above to share their story even though their names were not used.

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