Wealth & Wisdom
INSTITUTE

ELIMINATING LOSING FINANCIAL STRATEGIES

Insurance
Understanding Policy Secrets

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I Don't Mind Dying, I Just Don't Want To Be There When It Happens.

Insurance

If something has no value don't insure it! The insurance industry is one of the few industries that has created more confusion than clarity.

Life & Death

What would you call someone, who lived a couple of houses down from you, that in the middle of the night, left his wife and three kids? He left them with no means of support and a lot of debt. What adjective would describe this person?

What would you call someone, who in the middle of the night, died, and left his family with no means of support and a lot of debt? The adjectives would be a little different, but the results would be exactly the same.

Now, if we took the same scenario and said he died in the middle of the night, but left his family a large life insurance policy, what would you call him? A loving husband and father? That gift of love to his wife and kids expressed that his commitment to his family did not end with his last breath, but lived on into the future. He was there in sickness and in health, in life and in death.

I know this is a sensitive subject and it isn't fun to talk about, but it is an important subject and in many cases misunderstood. Once again, I'm going to ask you to think a layer deeper on this topic. What you hear about life insurance from others, may not necessarily be true. Advice you received about life insurance may be based more on opinion than fact. Insurance companies that produce these products will always profess to be the best. Have you ever seen an advertisement where a company stated that their product is mediocre? There are good products and bad products out there, so, marketing that is based on price of the life insurance is flawed. Cheaper is <u>not</u> better, in most cases. If you used that philosophy for everything you bought you would end up with a house full of junk. I have seen a lot of competition based on price, but very little on the provisions of the insurance contracts.

Hodgepodge Of Policies

An insurance contract is a legal document, an agreement to pay benefits in the event of loss, in exchange for a premium. There are many different types of policies available to the public. There are universal life, variable life, whole life, survivor life, modified whole life, blended whole life, term life, decreasing term, increasing yearly term, etc. The creative list goes on and on. To add to the confusion, each company's policy provisions may be different for each of these types of policies. No wonder consumers cringe when they hear the words "life insurance."

Cash Value

I could spend several boring weeks explaining different types of life insurance. I don't want to do that, however I do want to address the concept of cash value life insurance compared to term insurance. Cash value insurance policies build up values inside the contract either through the payments of dividends, interest rates or investment returns. Over a period of time, these values could add up to a tidy sum. It is frowned upon to call this an investment vehicle, but you can't ignore the fact that policy values, if used properly, are a valuable financial asset.

Term insurance policies are bought for a specific term of time. The most common term lengths are ten, fifteen and twenty year policies. Term insurance builds up no cash value. Some companies profess to have some cash value term. In most cases though, there are no values in these policies. The insurance company needs not set aside any cash reserves for term, resulting in the policies being sold at a much cheaper premium than cash value policies.

Insurance Transfers Of Your Wealth

No matter how you think about it or what type of policy you buy, you will transfer dollars to pay premiums. The decision you make whether you buy cash value insurance or term insurance could be a costly one. If you could recapture the dollars you will pay in premiums on a policy, would you do it? In the end, life insurance can provide options and opportunities and can resolve a number of financial problems at one time. Life insurance creates protection, monetary value, and can have favorable income tax and estate tax results. Learning to use your policy is as important as buying it.

How Much Is Enough?
"Clean Up In Aisle Four!"

Determining the amount of insurance one should have is a major issue. You will get different answers from different professionals. It's amazing to me how one evaluates ones life value. Let's say you own life insurance with a death benefit of $100,000.00. You assumed, for reasons no one can explain, that it was a sufficient amount. While you are shopping at the grocery store, a condenser in the frozen food section explodes, leaving you and two hundred pounds of prime beef spread all over the place, i.e. you're dead. Your family hires an attorney to sue the store. The value of your prematurely-ended life, in the court case, is determined to be $10 million dollars. Now, that is a pretty wide spread between what you thought your life was worth compared to what the attorneys and judge thought. Your family is happier with their evaluation than yours.

Self-Inflicted Tax

I have seen it happen. People will go on the Internet and buy one million dollars worth of term insurance, not knowing they may have just created an estate tax problem for themselves. If the proper estate planning is not done, the death benefit of the policy could be included as part of your estate. Before you bought that policy, you may not have had to pay Estate taxes, but now with the value of the policy added in, you created a mess.

Buy Term And Invest The Difference?

The most common marketing ploy for term insurance tells us to buy term insurance rather than cash value insurance and invest the difference. If that's such sound advice, why don't we apply the wisdom more often? For example: Buy folding chairs, not a couch, and invest the difference. Buy a push mower, not a power mower, and invest the difference. Buy a bicycle, not a car, invest the difference. Buy a shovel, not a snow blower, invest the difference. Buy a pet, don't have kids, invest the difference. Buy scissors, cut your own hair, invest the difference. Buy just aspirin, not your prescriptions, invest the difference. Stay at home, don't take the spouse out, invest the difference. Move back in with your parents, sell your house, invest the difference. Visit the mall, instead of taking a vacation, invest the difference. It seems this philosophy works with everything! Simply extract value, and invest the difference.

The marketing of term insurance is an art form in itself. From the Internet, banks, television deals and mass mailings, to auto insurers, mortgage companies and brokerage houses, it seems to be very popular. Why? Well, here are the term insurance facts. Less than one policy in ten survives the term for which it was written. The average life span of a term policy before termination or conversion is 2 years. 45% of all term policies are terminated or converted in the first year. 72% of all term policies are terminated or converted in the first three years. Finally, and the most glaring statistic is that only 1% of all term policies result in a death claim.[1] Insurance companies love term policies, and clearly term policies are very profitable for them. So they market the heck out of these policies with little fear of having to pay out death benefits.

If There Is Money To Be Made. . .

Investment people, accumulators, those who invest your money for you and charge a fee also want you to buy term insurance. It stands to reason they want you to spend less on everything so you can invest the difference with them, so they can make more money. Regardless of the statistics on term insurance, they will tell you it's the wise thing to do. Banks also push term insurance. Much like the accumulators, they don't want you to spend too much money on insurance because they are afraid they will lose money that would normally flow into savings and CD accounts. You can see why

[1]Penn State University, 1993 Study on the Fate of Term Insurance Policy.

there is such a groundswell of support for term insurance. It's called PROFITS! Their profits, not yours.

Let's Do Some More Math!

It would be reasonable to say that renting an apartment would be cheaper than buying a home. On a month-to-month basis it is cheaper to write a rent check than a mortgage payment, which includes property tax and homeowner's insurance. But if you evaluate this scenario on a long-term basis, 20 years down the road the house has built equity, while the apartment gives you nothing in return. Although rent may be cheaper, it doesn't build equity.

The same can be said about term insurance. Term insurance is like renting, while cash value insurance is like owning since you build equity. If you are interested in recapturing your dollars you buy a house, you don't rent one. If you would like to recapture the dollars you paid in premiums for insurance, own it, don't rent it.

Let's take a look at 46 year-old male, who is in good health and doesn't smoke. He applies for $250,000.00 worth of term insurance with the understanding that, according to the television commercial he saw, it will be cheaper. Using a 10 year term for a select nonsmoker, the annual premium would be approximately $345.00. In 10 years when that term expires, he wants the same coverage of $250,000.00, but to buy another 10 year term policy the premium would be about $697.00 per year. This, of course, assumes that term rates didn't increase, and that between the ages of 46 and 56, he remained in good health.

At age 66, if he still wishes to maintain the $250,000.00 death benefit for another term of 10 years, the annual premium would be around $1,835.00. Again, we are assuming his health is the same as it was when he was 46, and insurance rates didn't go up. However, at older ages, maintaining select nonsmoker rates would become more difficult. With each 10 year term that passes, to maintain this coverage he would have to re-qualify medically, and be approved by the insurance company. It is not uncommon for someone to be denied coverage, or because of health reasons, be charged additional premiums.

He believes that his life expectancy is about 80 years old, so at 76 he purchased another 10 year term policy. Unfortunately, he dies just before his 81st birthday. His premium at age 76 could be $7,870.00 per year. Again, assuming that he was in the same health classification as when he was 46 years old. At 76, it is almost a certainty that the premiums would be higher than that due to health problems.

What did he spend during his lifetime to have $250,000.00 of life insurance? From age 46 to 56 he spent $3,450.00. From age 56 to 66, he spent another $6,975.00. From age 66 to 76 another $18,350.00.00 was spent on premiums. Finally, from age 76 to 80, the premiums paid came to $39,350.00.

Age when policy issued	Annual Premium for $250,000.00	Ten Year Cumulative Cost
46	$345.00	$3,450.00
56	$697.50	$6,9750.00
66	$1,835.00	$18,350.00
76	$7,870.00	$39,350.00
	TOTAL PREMIUMS PAID	**$68,125.00**

Had he been able to invest all those premiums on a monthly basis and averaged 7% rate of return, he would have accumulated another $65,138.00 in opportunity costs. So, the actual cost of this term insurance including the lost opportunity cost would be . . .

$ 68,125.00 PREMIUM
<u>$ 65,138.00</u> LOST OPPORTUNITY COSTS
$133,263.00

. . .a lot!!! Remember, that is assuming he had perfect health his entire life and insurance premiums didn't increase. That's a lot to assume.

Term vs. Cash Value

Let's take the same 46 year-old guy, buying one of the most expensive whole life policies he could buy. The annual premium for $250,000.00 of death benefit is in the neighborhood of $5,718.00 per year.[2] GULP! Remember, I wanted to use one of the most expensive policies I could find for this comparison. The $345.00 term premium for a 46 year old is far more attractive than $5,718.00 per year. However, in the whole life policy, the premium does not increase even though your health may change. Also, the whole life policy also builds up equity, or cash value. Under current values (values subject to change), at age 65, he would have paid $108,642.00 in premiums (19 years at $5,718.00), but the cash values built inside the policy are sufficient to continue to pay policy premiums for the rest of his life. Also, even as the premiums at age 65 are being paid by the policy, the cash value <u>continues</u> to grow.

If we compared just the base premiums of these two policies you could assume that the term insurance is a better buy.

$108,642 CASH VALUE PREMIUMS
<u>$ 68,125</u> TERM PREMIUMS
$ 40,517 DIFFERENCE

But over this period of time, the cash value in the whole life policy has grown to $357,908.00 at age 81. One might come to the conclusion that paying an extra $40,517.00 in premiums over 35 years netted you $317,391.00 ($357,908.00 total cash value minus $40,517.00 difference in premiums). Remember also that the values in the

[2] Ohio National Life Insurance Company, Executive Estate Builder, December, 2002 Rates for 46 year old male, select nonsmoker on $250,000.00 death benefit.

cash value policy have grown tax-deferred and can be taken out of the policy tax-free by borrowing values or withdrawing the basis. Consider how much money you would have to have in a 401(k) to net $357,000.00 after taxes. Probably about $500,000. The whole life, cash value policy, financially, is a much better buy.

There is another major consideration. Remember, in our example, this guy died just before his 81st birthday. The term policy would have paid out **$250,000.00** to his beneficiaries. The whole life policy would have paid out **$485,000.00**. That's **$235,000.00** more tax-free dollars to the beneficiaries than the term policy would have paid out. Which policy was the better buy? At age 80, a **$485,000.00** death benefit in a term insurance policy would have an annual premium of **$43,500.00**.

Is It Or Isn't It?

So, is term insurance cheaper over the entire lifetime of someone compared to cash value insurances? NO. Is term insurance cheaper for a short period of time? YES! Does term offer additional benefits other than the death benefit? NO. Can cash value policies be a financial tool? YES. Do investment people and insurance companies recommend term insurance? YES. Because it will be profitable to you? NO. Profitable to them? YES. There, see how easy that was?

Policy Secrets

Not everyone can afford $5,700.00 of annual premium. Whole life, cash value policies can be purchased for considerably less than what is used in my example. However, the lesson is: If you can recapture dollars you are spending for insurance, do it!

In whole life cash value policies, you have access to these cash values throughout your life. These values will grow tax deferred while the policy is in force. Access to cash values up to the premiums you paid into these policies can be withdrawn, surrendered or borrowed tax-free. Loans from the policies' cash values are tax-free as long as interest is paid. Loans for business purposes in these policies are tax-free and the interest can be tax-deductible. Learning to use your life insurance policies can be beneficial, but BEWARE! Some "professionals" consider these policies easy pickings to surrender or strip the values out of them. BEWARE! IF AT ANY TIME, ANYONE RECOMMENDS THAT YOU DISCONTINUE A CASH VALUE POLICY, YOU MAY LOSE:

1. The immediate, income tax-free death benefit protection under current law;
2. The loss of the tax deferral features;
3. The death benefit, which can assist in meeting IRS demands on your estate;
4. The flexibility of a personal source of loans at a low cost;
5. A wealth accumulator, tax planner, a conduit for money, a source of flexibility, security, and liquidity; and
6. Future accumulation of your dollars because surrender charges could apply to your cash value.

A Secret Weapon

When used properly, these policies are very valuable.

- Under current tax laws, a cash value policy permits tax-deferred accumulation of money. Under current tax laws, the IRS will impose no tax on this policy unless you surrender it or allow it to lapse. If you do so, they will tax the gains. The policy therefore can shelter you from taxes on any growth in the policy as long as it remains in effect.

- If your cash value has a waiver of premium and you become totally disabled by contract definition, the insurance company will make premium payments on your behalf to your contract. This will allow more freedom in how you use your discretionary funds for investment purposes.

- The cash in this policy is protected from creditors, absent fraudulent intent.

- This policy can help you fund your retirement by allowing you to spend your assets differently than if you retired without this insurance, assuming your insurance is in force at the time of retirement.

- Because this policy has a death benefit, in certain, limited circumstances, a reverse mortgage on your home may be used to create additional cash flow. You will be able to retain the house in your estate when you die through repayments to the bank using the death benefit.

- When you retire, you will not be confined to living on just some of the interest of your investments. The presence of this policy may allow you a great deal more freedom in the utilization of all of your other assets.

- You may, at a later age, use the death benefit as collateral for loans. Through leverage, the death benefit will be yours to spend. You can be a benefactor of your own policy. It is a unique piece of property.

- This policy will help in your estate planning to pass assets directly to your beneficiaries.

- This policy will develop cash for you in other ways. You will have a personal source from which you may borrow. Thus, on loans, you will save the interest, instead of sending those dollars off to a financial institution.

- Finally, don't forget what this policy can do for your family in the event of your death. They will be able to continue to live, and grow, and keep up with inflation, and retire just as you wish them to do were you alive.[3]

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[3] Jerry LaValley, CLU, *The Power of Whole Life Insurance*, correspondence dated May 22, 2002.

A Secret Bank

As with the assets in your home, a cash value life insurance contract can be viewed as establishing another "bank" in your financial future. It could create financial options and opportunities when combined with other saving vehicles. It gives you liquidity, use and control of your money.

Let's say as an example, you did put $5,000.00 of annual premium into a cash value life insurance contract for 10 years. Your basis on this policy would be $50,000.00 ($5,000.00 x 10 years). During those 10 years, the equity had grown to $70,000.00 of cash value. You could withdraw $50,000.00 out of this policy (your basis) without creating a taxable event. This is so because the values are treated on a FIRST IN, FIRST OUT basis, thus the withdrawal of this $50,000.00 would be viewed as a return of basis and not taxable. However, if you requested the other $20,000 in the policy's values it would be taxed as ordinary income. You can avoid this tax by taking it out as a loan on the policy. The insurance company would let you use your policy as collateral on this loan. Policy loans do not disrupt life insurance's cash values. The insurance company lends you the money using your death benefit as collateral. Therefore, the cash values continue to grow regardless of the loan. Most companies offer very low net cost in borrowing against your cash values. Some contracts even have 0% net cost loans.

Your Bank Not Theirs

Once again, gaining control of your money is most important. Controlling the tax-free equity in your home, and establishing cash values inside life insurance policies to grow tax-deferred with favorable withdrawal and loan provisions, will be valuable financial tools for you. These two personal "banks" will help eliminate or reduce transfers of your wealth in the future. Eliminating or reducing transfers to others will save you an enormous amount of money that you are currently willing to give away. By using your "banks" you can eliminate or reduce fees, charges and interest that you are currently paying to others. By using your "banks," you can reduce the net costs of your loans, and in some cases deduct the interest on loans from your income tax. Remember, at your "bank," all the money you pay back goes back into your "bank" not theirs.

It Was Too Good To Be True

Back in the 1980's, the government made an amazing change. In the midst of eliminating almost all the tax deductions available to taxpayers, it also corralled another enemy of taxation: Cash value life insurance. The tax reform acts of the 1980's made it very clear that life insurance was a formidable foe of taxation. At that time private citizens, with no help from the government, could purchase life insurance, create cash values and escape a lot of taxation. The government was appalled. As the government has its own savings programs, such as the IRA, they really didn't need or want any competition from the life insurance industry. You see, cash value life insurance policies were offering many more benefits than Ira's offer, so the government sought to control and limit life insurance policies. The public suffered the brunt of these government reforms, while the banks and investment companies applauded, since they were also direct beneficiaries of the regulation. For the government, it meant greater ways of taxing the public, and for the banks and investment companies, it meant a greater revenue flow.

All Was Not Lost

What the government set out to do was to limit the amount of money that a person could put into a life insurance policy. Cash value policies offer tax deferred accumulation of values and well-informed people at that time were putting as much money as they could into these policies. The tax reform acts of the 1980's did limit the amount of money that can be put into cash value life insurance. Lucky for us, what they failed to do was to reduce the benefits within the policies. The next time you consider opening an IRA or other investment account, consider whether it offers any of the following benefits, which are inherent in many cash value policies:

- TAX-DEFERRED GROWTH. Outside of qualified plans, mutual funds, CD's, stocks and other investment products don't offer tax-deferred growth of your money.

- COMPARABLE RATES OF RETURN. Everyone advertises great rates but you must also take into consideration taxes, and whether you can maintain liquidity, use, and control of your money.

- GUARANTEES. Do mutual funds and stocks offer specific guarantees or are you exposed to losses?

- SAFETY. Can you sleep at night knowing your investments will be there when you need them?

- ACCESS. Can you get to your money or is it locked in place because of fees and/or penalties?

- CONTROL. Do you control the outcome of your investments or does someone else? When someone else controls your money it usually ends up costing you more!

- DISABILITY. If you become disabled, will your bank or investment people, on your behalf, continue to deposit money for you on a monthly basis because you physically and financially are unable to? Will they continue to make these monthly deposits until age 65? No.

- PROTECTION FROM CREDITORS. Will creditors, for the purpose of collecting debt, have access to your stocks, mutual funds, retirement plans, bank accounts, and CD's? Yes.

- TAX-FREE WITHDRAWALS. Do your retirement plans, stocks, CD's, and/or mutual funds offer tax-free withdrawals or will you have to pay fees, penalties, taxes, or all three to get your money?

- PROBATE. Do your retirement plans, stocks, mutual funds, real estate, bank savings, CD's, and other savings programs, in the event of your death end up in probate court?

- INSURED. Are your stocks and mutual funds insured for failure?

- DEATH BENEFIT. Do your mutual funds, CD's, or stocks give your family sums of tax-free money upon your death?

- SELF-COMPLETING. Are any of your investments self-completing? This means if your intention of saving and investing money was projected over a 30 year period, and you die after only 5 years, your family would still receive the other 25 years of investments and earnings that had been planned on, tax-free. Would the banks, government, or investment people do that for you?

The features listed above are some of the benefits that escaped the legislation of the 1980's that remain benefits in cash value life insurance.

The Corridor

Who determines the cost of term insurance? The insurance companies. Who determines the cost of cash value insurance? The government, by regulation.

Cash value insurance Government regulated

THE CORRIDOR

Term insurance Industry regulated

The government regulates and limits the amount of money you can put into these policies. If you put more money into a cash value policy than government regulations allow, it becomes a modified endowment contract and will be treated and taxed as qualified plans are treated and taxed. We can deduce that a maximized cash value policy, with its tax advantages, is the best policy you are allowed to have by law.

Qualified Plans

Cash value insurance	Government regulated
Tax-Deferred Growth	Avoids Probate
Competitive Rate of Return	Insured
Safety	Some Guarantees
Access to Your Money	Tax Free Death Benefit
Control	Tax-Free Withdrawals
Disability Features	Protection from Creditors
Term insurance	Industry regulated

Looking at all the benefits listed in the diagrams above, would you agree that cash value life insurance would be a good place to park at least some of your money? Learning how to use this vehicle during your life can become a very valuable financial tool. By regulating it, it's obvious that the government sees it as a valuable financial tool, why don't you?

Why You Buy

As you can see, much time can be spent talking about life insurance. What it really breaks down to is this: Need vs. Want. While you're alive you want your family to have the best that your lifestyle will allow. The best home, the best car, the best education, etc. What about if you die? Do you want your family now to get by on simply what they need, a small home, a run down car, and no money for the kids' education? Is that the commitment you made to your family? The question is, WHAT DO YOU REALLY WANT TO HAPPEN IF YOU'RE NOT THERE?

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