Life Insurance: Before you "Drink the KoolAid" There are some things you should know

How many times do we see the cult-type life insurance agent at the kitchen table explaining how a life insurance policy can fix just about anything? College funding, "How about a nice Cash Value Policy?" Family Protection, "Whole life is the way to go for you!" Retirement, "Extra money in a policy can give you tax free loans!" Divorce, "How about a large term policy? "...okay..that was wrong. They come in a uniform type suit, not a hair out of place with gel in it, neat as a pin, and sell you in believing all your troubles can go away by signing at the dotted line. They deliver your gold-plated policy, collect their upfront commission, and you never hear from them again stuck with a customer service number if you need help or have a question.

Carlucci's Corner

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This article is being written because I am constantly running into clients, friends, and colleagues that are grossly misinformed about the proper uses of life insurance. I think it is our duty as professionals to understand the things we sell before we present them to the client and general public. I want you to have some general knowledge on complicated matters. I hope it helps!!

Let me first say that I am all for Life insurance to meet a certain need or needs. The problem is, in my experience, is that many agents don't sell the appropriate

product for the client's custom situation. Additionally, some of the so-called tax benefits with life insurance can become tax-traps that the policyholders never saw coming and were never even warned about by their insurance agent "clone" that served a nice pitcher of KoolAid with a perfect whitened-teeth smile. No offense folks, I am sure these are all nice people with families etc., but you deserve options and you should demand to know any potential consequences.

Allow me to shed some light on the facts about certain life policies and some suggestions on how they can be properly used.

Income replacement and family protection

Many families are vulnerable if the bread-winner should suffer an untimely death when they are dependent of their income to not only survive, but keep the relative standard of living they are used to. Young children and a stay-at-home spouse are usually the most vulnerable. Understanding every family situation is different, and people's finances are also different. Let me offer some general opinions here. Personally, I believe a 30 year or less term policy that can be converted into a permanent life product without a new medical exam is the first and best option for this situation in most cases. But there are some viable reasons to choose other products. Many folks say "But if you live there is nothing for you at the end of the term....no value." This is true, but the idea is to invest the difference between the much larger cost of a permanent policy into other areas. The problem for many families is that they just don't do it. Many would prefer a forced-savings type of insurance and they can afford the higher payment. For that minority portion of the norm, I may suggest doing one of two things. A nice fact under current tax law regarding cash value policies is that the cash value is treated as F.I.F.O. (as long as the policy is not a MEC) which means first-in first-out with withdrawals. Here is an example....let's say over a 30 year period you paid premiums of $60k ($2k per year). This is your cost basis in general (you should first call your insurance company and verify your cost basis and report if there are any surrender charges). Let us also say that at the same point in time your cash value is $74k. Check with your insurance company first,

but if you withdrew the roughly $60k cash value amount in general you can get that money back without taxation due to the F.I.F.O. rule. So, let's say your kids are grown and you have a nice retirement nest egg and no longer need the insurance, you could surrender the policy in full and keep most of your cash value. Personally, I haven't seen too many policies that performed too well after incurring the internal costs of insurance. If you are not a great saver, but can afford the higher cost of a cash-value policy, this may be an option for you. Why not keep the policy and pay no more premiums? This does work out sometimes but you need to realize that in many Universal Life policies the internal expenses rise as you get older. There will come a point of critical mass where your interest or dividend is less than the cost and your value will start to erode. Most policies lapse worthless which gave rise to the Life Settlement industry (another nightmare). My opinion, in many cases, is that you may consider taking out your funds at a point you don't need the insurance. This option, and any other suggested in this article, should be reviewed with your CPA and an insurance professional that you trust in regards to your custom financial and family situation.

Another option quickly rising in popularity is the return-of-premium term policy products that a few life companies now have. What's that you say? An example would be the same term policy I mentioned above, but at the end of the term you get all or most of your premium back from the company. Sounds wonderful right? Well, the premiums are much higher than regular term because the life company takes your additional premium and invests it themselves over that time which is how they are able to pay you back and make money on it themselves. This is a nice idea, but I think the prices are too high. I would lean towards a cash value option and withdraw when you don't need the insurance. I will always say though, "Buy insurance, for insurance!!!!! Not an investment". Don't worry, I do believe in permanent products too, but for the insurance, not any retirement plan or bogus tax-free loan etc. etc.. Conclusion, in my opinion, in most cases is a 30 year convertible term policy and invest the difference for income replacement and family protection.

Permanent Insurance for estate planning and retirement enjoyment

I believe that permanent insurance has its place in the world and can be very useful in Estate planning, making sure some loved ones are provided for, and to allow folks to enjoy their retirement a little better. This is actually my area of specialization and do place millions of dollars in insurance. But it is for the insurance, not for an investment. The only product I will generally sell someone for a permanent product is called "Guaranteed Universal Life" or "Survivorship Guaranteed Universal Life". We, in the industry, call this "rich man's term insurance" because it is the lowest priced in the industry and you can guarantee to a certain age. For example, Insurance companies presently assign their risk out to age 126. If you are fortunate enough to live to age 126, best of luck. Not me!!! You can choose an age to guarantee to like age 105. This will reduce the premiums that are quoted from a policy from age 126. This guarantee basically means that as long as you pay the premium on time, your death benefit won't go lower and your premium won't go up. Lincoln National Life actually just rolled out a guaranteed product that you pay to age 100 but will guarantee you to age 126 anyway, I love that one :>. If you believe your marriage is solid and will last to death, you may consider a survivorship policy which requires both you and your spouse to die before paying the death benefit, but in many cases, is around half the premium of an individual policy. This is one of the most preferred products for estate planning as the estate taxes are usually incurred on the second spouse's death.

There are many "KoolAid serving" agents that would go nuts reading about my suggestion of guaranteed universal life. That is because it goes against the brainwashing they got at Planet Clare when the spaceship kidnapped them for training. Whole Life is really expensive, which yields higher commissions than GUL or SGUL. Starting to make sense ? :>. I once competed with a "clone agent" captive with one company swearing by whole life and against GUL. I asked him to tell me and the client why he disagreed with my suggestion. His response, "well, if you don't pay the premium they cancel the policy". Wow, you really got me there bub!!! LOL. One reason GUL is relatively cheap is because they don't make you "load the boat" with excess unnecessary cash value. Again, if you are buying the insurance for insurance you are better off, in my opinion, investing your cash elsewhere. If your GUL policy did not have enough cash value to support the premium you would get the mandatory 30 days grace and 30 days additional to reinstate. One measure to protect against missing a payment is to send the premium notice to a couple of different family members or loved ones. I am sure there are still a few situations that whole life works, but I have yet to run across them. Good to compare and decide yourself. That was the only ammo the agent could use. Winning!!!

Another good use for permanent insurance is for providing for loved ones or creating a dynasty trust. You may have a special needs child in your family, or are worried for the financial well being of a loved one. You take care of that person as best you can while you're alive but want to provide additional protection when you die. Perhaps you have an adult child that has had a rough life and this could make things just a bit easier. Many "loved one" reasons to purchase permanent insurance.

Here is a reason for permanent insurance that myself and a colleague usually bring up. As Estate planning is my specialty, I see couples that constantly have differences of opinions about leaving enough money to their children and grandchildren. One will want to enjoy the money while they are alive, and the other feels guilty about spending the funds because that will leave less money to their heirs. One possible solution I suggest is to purchase a Survivorship Guaranteed universal life policy in a trust that is income and estate tax free that will allow the couple to enjoy their retirement nest egg(less the cost of the policy) with no guilt knowing their heirs will receive at least that sum of money tax free.

Necessary facts that most people or agents don't know or understand. Life insurance proceeds are generally income tax free, but they are not estate tax free!! That means, if you own your policy for $1mil, for example, when you die that $1mil amount is added to your estate. If you live in my home state of NJ where the estate tax applicable exemption is only $675k your heirs will be paying tax on $325k , approximately $40k-$50k in unnecessary taxes. Solution, have an irrevocable trust own the policy.....longer term policies should also go into an irrevocable trust if you have an estate issue if you have lawyers like mine that will draft a trust for a onetime payment of $1k. You can transfer a presently owned policy into an irrevocable trust, but you must outlive the transfer date by 3 years or the death benefit will be included in your estate.

A new IRS regulation for all you company owners that own life insurance for a buy/sell agreement or key employee insurance.....you need to file a IRS form 8925 every year you own the policy or you may not receive the income tax free death benefit. Insurance companies do not have the onus to tell you. It's up to you and your professionals.

Last, but certainly not least, is a dynasty trust, which has sometimes been described as a way to taste immortality. Ancient warriors were obsessed with doing something in their lives to be remembered making them somewhat immortal. Well, you could (depending on what state you live in) create a trust using Life insurance that will fund the trust when you die. The trust could stipulate that anyone that will benefit from the trust get life insurance on their lives as well with the trust owning it. With this type of trust, there is no distribution in full. Beneficiaries can get the income and portions of the principal as the trustee sees fit according to your wishes when you draft the document. The assets inside the trust are protected from divorce and spendthrift's creditors. Because no ownership of the assets is ever changed from the trust while inside, the assets in the trust are not taxed through generations under current tax law. Hence, calling it a Generation Skipping Trust and can last for hundreds of years if funded correctly and if the laws against perpetuities in your state allow it. How are you immortal? Well, the trust will be named as you see fit which usually winds up yourself. Perhaps a direct family member from 150 years in the future actually is helped out through life by you and your strategic planning? He/she would most likely want to know more about you. Some people are rich enough to have a wing on a hospital built in their name, some prefer to help their own bloodline prosper. Interesting huh?

Never borrow money from a policy unless you have to!

Let me be abundantly clear here folks! There are ways to secure retirement funds from a life policy with a tax free loan and actually come out ahead. It is usually the folks with giant policies with a team of professionals analyzing their situation annually etc. For the rest of us poor slobs we have to go it alone. We remember the agent saying if you need money just borrow it tax free!!! no problem!! Which may have been a compelling reason for your purchase. Here it is.....are you ready? If you borrow from a policy, and the policy lapses or is reduced via death benefit below a certain level, you will receive a 10-99 for that total borrowed amount as regular income tax payable in that tax year folks!!!

I had a client that had his policy reduced because he borrowed money to pay taxes and kept paying his premium out of cash value, and he had to pay ordinary income taxes of over $75k in that tax year. He had no clue this could happen and most agents have no clue it could happen when they sell this stuff. They are nowhere to be found as this is 20 years or so later. Selling responsibly requires the proper education of how products should be used and the potential tax traps that can affect them. So many nice people are misinformed about the consequences of these so-called tax benefits and find them out when it's too late. You may be wondering why the life company doesn't tell you. Well, somewhere in the policy in tiny print is a disclaimer saying you could have adverse tax effects etc, or in tiny font somewhere else that no one will read. The uneducated agent certainly won't bring it up or read it. Here you go.....in my humble opinion, insurance companies want you to borrow as much as you want. The more you borrow, the more likely your policy will lapse before you die. If the policy lapses, they don't have to pay a death benefit. That means they just collected your money most of the life of the policy and didn't have to pay anything out!!! Make sense?

Never, ever, borrow money from a policy to pay taxes

I am afraid there is more disturbing news. There are life companies now that are pushing some bonus alternative using cash value life insurance where they encourage you to pay taxes on your incoming bonus out of the policy cash

value. A business owner will pay a bonus into a life policy designed for cash value which gives the business owner the full deduction tax wise. The receiving employee owes taxes on those new funds. Those taxes are encouraged to be paid out of the new funds from the policy which begins adding up the debt. To avoid the taxation problem, they suggest adding a no lapse safety rider on the policy(costs more). This will protect you from the policy lapsing, but guess what? When that rider kicks in, you can't get any money out of the policy or get a death benefit. It freezes!!! Why bother????!!!! Stay far away. Tell your boss you'll just take a bonus check and pay the taxes and keep the remainder. This stuff happens every day, and you need to understand what you are doing before you pay the piper.

Things you can do to help

1) Use an independent life insurance agent!!!! The way insurance companies price sometimes has to do with how many applications they have in at any point in time and how their risk ratios look. Metlife, for example, may need more policies in a quarter and lower their rates, while Lincoln may have their fill and raise their rates. Companies pricing will vary at any point in time. When you work with an independent (like me :>) you get the top 10 prices among top rated companies. What do we care what company you use as long as they have a good financial strength rating?

You will get the most competitive price at the time. If you have the KoolAid agent that is captive and can only sell his/her companies insurance you are subject to that price. that may be the best price at the time, but you should shop around first.

2) As I always say, earning my CFP Certification was one of the most enlightening experiences of my career. I learned what I didn't know!!! I suggest working with a CFP that understands how each facet of financial planning, in this case insurance, interacts with each other. Understanding taxation and

possible tax traps is imperative in proper planning. Stay away from the stereotype cult member with a pitcher of KoolAid!!!

3) Buy Insurance for the Insurance!!! I highly recommend you stick to the basics and leave the cash retirement uses in other vehicles unless your team of professionals are really doing annual reviews and coordinating with each other. The cheesy annual birthday card does not count as a review!!!

4) If you currently have a cash value policy that is not guaranteed and you are still in decent health, consider rolling the policy over tax free through a 1035 exchange and purchase guaranteed universal life or survivorship guaranteed universal life. You may be astonished at the difference in premium. Worth a look at least.

5) Do overall budgeting analysis and purchase the proper policy that is affordable not only for now but in the future.

...and most importantly.......

6) Don't drink the KoolAid!!!!!!!!!!!!!!!!!!!!!!!

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