

USING VARIABLE LIFE INSURANCE AS AN INVESTMENT ALTERNATIVE

By Peter Katt

Variable life's advantage for the dual purposes of family protection life insurance and investing depends on the investment returns, the investment strategy pursued, and how the money will be withdrawn. However, the wealth-transfer advantages of variable life appear to be consistent under many different scenarios.

The two most common client situations I see are: those in their 30s, 40s or 50s who have dual needs for family protection life insurance and investing beyond what they can contribute to their qualified plans; and those in their 50s, 60s and 70s who have acquired more wealth than they want for their own needs who wish to transfer wealth to their children in an estate-tax-wise fashion.

Because permanent life insurance has such significant income tax advantages, it ought to be considered for both of these two common client situations. The intent of this column is to present the results of an extended analysis that compares using variable life insurance with conventional investing for these two situations.

PERMANENT LIFE INSURANCE

Permanent life insurance can be placed into two broad categories:

- Whole and universal life that is *bond*-based; and
- Variable life that can be *equity*-based.

Because of its significant income tax advantages, bond-based life insurance, purchased from quality companies that give fair treatment to all policyholders, will always outperform similar investing outside of life insurance because fixed-income yields are reportable as income each year, whereas the values built-up inside whole and universal life insurance are not reportable. Therefore, clients with either of the two common identified situations who choose to use only fixed-income investing will do far better with life insurance because of the huge tax savings. But things get more complicated when comparing these two situations for those who wish to use equity and balanced investing because the taxation on accumulations and withdrawals is far more complex. Thus, this column deals only with equity and balanced investing available in variable life.

FAMILY PROTECTION NEEDS

Thirty-, 40- and 50-something high-income earners whose families are financially dependent on them need significant amounts of family protection life insurance, and they frequently are able to invest more than their qualified plans will allow.

One strategy is to buy term insurance to cover family protection needs (which dissipate as the family's wealth increases and the children grow up) and invest in conventional ways via various mutual funds. Conventional investing is subject to typical taxation while being accumulated and when withdrawn for various purposes such as a vacation home, education expenses or as a supplement to retirement income.

Another strategy is to combine the insurance and investing into a variable life insurance policy whose accumulations are free from taxation and some or all of the withdrawals may also be free of taxation.

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Take, for example, Mark, a 44 year-old physician, who wishes to add \$1 million to his family protection life insurance program and also wishes to invest around \$50,000 annually until age 60 to supplement his retirement income. A \$1 million term insurance policy has a level annual premium of \$1,310, leaving \$48,690 that can be invested annually in mutual funds. Alternatively, Mark can purchase a variable life insurance policy with annual premiums of \$50,000 whose minimum death benefits (increased by the cash values) are \$1,000,000. This policy configuration of minimum death benefits, relative to the \$50,000 premium, enhances the investment component and is the appropriate policy design when life insurance is used for the dual purposes of family protection and tax-deferred investing.

For the purposes of analyzing whether variable life is a better alternative to buying term insurance and conventional mutual fund investing, the following assumptions and factors were used:

- Total monies available for insurance and investing annually was \$50,000.
- Funding continues for 16 years (to age 60), then monies are taken out in amounts that will allow for a significant balance to remain even if Mark lives to age 100 (when the variable life policy matures). The actual amount taken out is a function of how much has been accumulated and will change as investment conditions fluctuate.
- A \$1 million 20-year level term insurance policy with a super-preferred rating has an annual cost of \$1,310, leaving \$48,690 available to be invested in a mutual fund. The term insurance is terminated in 16 years.
- Variable life insurance has a specified death benefit of \$1 million plus the cash value until age 60, when it is changed to a level death benefit; \$50,000 is

paid into the variable life policy until age 60, then the same amount of aftertax monies are taken out to match aftertax monies taken out of the mutual fund.

- There are two methods for taking monies from the variable life policy. One is to withdraw monies each year; withdrawals are a tax-free return of principal until the amount of premiums paid are equaled, at which point they are taxable as ordinary income. The other method is to take withdrawals up to cost basis, then take loans that have a net zero cost because the interest credited to the loan balance is the same as the interest due on the loan; policy loans are tax-free as long as the insured dies with the policy in force. However, using net zero loans has several potential problems. First, it is conceivable that Congress will curtail the use of this tax-avoidance device, and it is possible they could do it on a retroactive basis. Second, net zero loans are not guaranteed: Insurance companies could begin charging real interest that might cause a policyholder to change previous loans to withdrawals with an unexpected tax to be paid (although this would leave Mark in about the same position as if he had taken taxable withdrawals in the first place). And finally, if a policyowner doesn't pay close attention and the policy terminates, the huge amount of net zero loans taken would become income and subject to taxation. This could be a disaster because all of the monies previously taken out may have already been spent leaving no actual monies available to pay the unexpected tax. However, a variable life policy properly managed can safely use net zero loans by making adjustments to the amount of loans taken and death benefits as fluctuating investment results are booked. For this reason, individu-

als are best off using professional management of their variable life policies if net zero loans are used.

- Monies withdrawn from the mutual funds were taxed as capital gains.
- Three alternative investment strategies were assumed:
 - Index fund on a buy-and-hold basis:* An index fund minimizes the tax impact of a mutual fund. Based on comparing the gross yield with the tax-adjusted yield for Vanguard's S&P 500 index fund an average tax impact of 8% for the index fund investment was used. That is, an assumed 10% mutual fund gross yield had an aftertax return of 9.2%. Direct investment expenses were the same for both variable life and a mutual fund.

Balanced fund on a buy-and-hold basis: Because balanced funds use bonds, whose yields are subject to income taxes each year, the assumed income taxes were 18% as determined by comparing a Vanguard balanced fund's gross and tax-adjusted yields. Higher mutual fund income taxes favor variable life because their cash values are protected from any taxation during the accumulation phase and may be protected during the distribution phase. Direct investment expenses were the same for both variable life and a mutual fund.

An aggressive, actively managed mutual fund purchased on a buy-and-hold basis: Using various Vanguard funds, the average annual tax exposure for actively traded funds was 11.6%. This investment approach also favors variable life because of higher tax activity. Direct investment expenses were the same for both variable life and a mutual fund.

- Assumed average investment returns of 8%, 10% and 12% were used for both equity funds (index and actively traded); assumed average returns of 6.16%, 7.7% and 9.24% were

TABLE 1. VARIABLE LIFE VS. MUTUAL FUNDS FOR FAMILY PROTECTION AND INVESTING

| <i>Investment Strategy: Buy-and-Hold an Index Fund</i> | | |
|--|---------------------------------|------------------------------------|
| <u>Variable Life Performance Relative to Mutual Fund</u> | | |
| Investment Return | Using Variable Life Withdrawals | Using Variable Life Net Zero Loans |
| 8% | -41% | -1% |
| 10% | -12% | 4% |
| 12% | EVEN | 8% |

| <i>Investment Strategy: Buy-and-Hold a Balanced Fund</i> | | |
|--|---------------------------------|------------------------------------|
| <u>Variable Life Performance Relative to Mutual Fund</u> | | |
| Investment Return | Using Variable Life Withdrawals | Using Variable Life Net Zero Loans |
| 6.16% | 3% | 8% |
| 7.70% | 23% | 26% |
| 9.24% | 37% | 39% |

| <i>Investment Strategy: Buy-and-Hold an Aggressive Actively Managed Fund</i> | | |
|--|---------------------------------|------------------------------------|
| <u>Variable Life Performance Relative to Mutual Fund</u> | | |
| Investment Return | Using Variable Life Withdrawals | Using Variable Life Net Zero Loans |
| 8% | -32% | 21% |
| 10% | 5% | 25% |
| 12% | 21% | 24% |

used for the balanced fund. (Note—using an average return is only for comparative purposes. Assumed average returns should not be used for executing such planning because investments results will be volatile and unpredictable. This in turn makes distributions during retirement unpredictable and in need of year-to-year management which can't be seen when projections show an average constant return.)

Table 1 compares the results of purchasing variable life, invested entirely in the designated sub-account, with purchasing term insurance and investing the difference in an identical mutual fund. A negative number means the term/side fund alternative produces greater value. All results are measured at Mark's age of 85.

The first section of Table 1 shows the results if the index fund strategy is used. *Do-it-yourself* investors will be better off using the term/side fund alternative because variable life's

apparent advantage for returns over 10% relies on using net zero loans, which require close professional supervision.

The second section of Table 1 shows the results if a balanced fund strategy is used. In this investment choice, the variable life alternative is clearly a better choice, especially if results average better than 7%. The advantage of using variable life does not depend on net zero loans, because all withdrawals will probably produce better results than the term/mutual fund alternative.

The third section of Table 1 shows the results if an actively traded fund strategy is used. These results are similar to the index fund strategy. *Do-it-yourself* investors must have confidence that their average returns will be greater than 10% for variable life to have a clear expected advantage when taking withdrawals. *Do-it-yourself* investors who lack confidence they will achieve an average return of 10% or better will be better off

using the term/side fund approach.

These results depend on a *buy-and-hold* strategy. Investors who believe they will re-position their investments between the time of initiating the program and their demise will certainly do better with variable life because of the tax-deferral advantage.

ESTATE PLANNING

Couples in their 50s, 60s and 70s who have accumulated more wealth than they want for their own protection and have more income than they want will frequently take steps to moderate the future maximum increase in their estate values by initiating a systematic gifting program. Cash gifts outside the estate (e.g., to an irrevocable trust) must be invested. This analysis compares *investing* in variable life versus conventional mutual funds. Because there is no need for family protection life insurance coverage no term insurance is used in this comparison. The following assumptions were used:

- Annual gifts of \$50,000 to an irrevocable trust.
- Three client scenarios used: a 60-year-old female with single-life variable life; a 60-year-old male insured with single-life variable life; and a married couple, both 60, using second-to-die variable life for the insurance.
- The variable life policy design has the minimum level death benefits relative to the premiums. With premiums of \$50,000 annually, the minimum level death benefits were: \$1,500,000 for the single-life female policy; \$1,200,000 for the single-life male policy; and \$1,900,000 for the second-to-die policy. The death benefits increase when the cash values become large enough to *engage* death benefits as proscribed by the tax code. Once the cash values and death benefits are nearly equal, the variable life policy is basically an investment

TABLE 2. VARIABLE LIFE VS. MUTUAL FUNDS FOR ESTATE PLANNING AND WEALTH TRANSFER

| <i>Investment Strategy: Buy-and-Hold an Index Fund</i> | | | |
|--|--|------------------|----------------------|
| | <u>Variable Life Performance Relative to Mutual Fund</u> | | |
| Investment Return | Female Single Life | Male Single Life | Couple Second-to-Die |
| 8% | 3% | 1% | 16% |
| 10% | 8% | 6% | 23% |
| 12% | 13% | 11% | 29% |

| <i>Investment Strategy: Buy-and-Hold a Balanced Fund</i> | | | |
|--|--|------------------|----------------------|
| | <u>Variable Life Performance Relative to Mutual Fund</u> | | |
| Investment Return | Female Single Life | Male Single Life | Couple Second-to-Die |
| 6.16% | 5% | 3% | 18% |
| 7.70% | 13% | 11% | 29% |
| 9.24% | 21% | 19% | 40% |

| <i>Investment Strategy: Buy-and-Hold an Aggressive Actively Managed Fund</i> | | | |
|--|--|------------------|----------------------|
| | <u>Variable Life Performance Relative to Mutual Fund</u> | | |
| Investment Return | Female Single Life | Male Single Life | Couple Second-to-Die |
| 8% | 6% | 5% | 20% |
| 10% | 14% | 11% | 30% |
| 12% | 20% | 18% | 39% |

Table 2 compares the results of purchasing variable life, invested in the designated sub-accounts, to investing a like amount in a mutual fund. A negative number means the mutual fund alternative produces greater value. For the single-life comparisons, results are measured at age 85. For the second-to-die comparison, the results are measured at age 90.

In every scenario tested here, it appears that wealth-transfer variable life is a better choice than conventional mutual fund investing. This result is due to variable life being completely free of any taxes while conventional investing is subject to taxes during accumulation and upon distribution. The variable life advantage would be even greater if wealth-transfer investments are periodically repositioned because of the taxes that would be incurred in conventional mutual fund investing that are completely avoided with variable life.

It should be noted, however, that these results only apply to individuals in their 50s, 60s and 70s. Results for younger individuals would tend to favor conventional mutual fund investing, especially at lower investment results.

CONCLUSION

This article compares the use of variable life instead of conventional mutual fund investing for the two most common client situations I see. Variable life's apparent advantage for the dual purposes of family protection life insurance and investing depends on the actual level of investment returns, how the accumulated assets are acquired during retirement, and whether the client plans on using net zero loans that are professionally managed.

The wealth-transfer variable life advantage appears consistent across the various scenarios tested. ♦

whose value will fluctuate based on the results of the sub-account investments. Note that if the sub-account investment performance is very low, or even negative, the variable life policy will do very poorly, and may be in danger of terminating with no value because of the large costs associated with providing even the minimum death benefits.

- Mutual fund investment was subject to year-to-year taxes as described for the family protection and investing comparison, and capital gain taxes upon the estate owner's demise because there is no step-up in basis since it is owned by an irrevocable trust. (Capital gain taxes would not necessarily be due upon the estate owner's demise, but they would be imposed whenever the mutual fund was liquidated. Therefore, for the purposes of comparing these two

wealth-transfer approaches, the mutual fund investment results are aftertax.)

- While the variable life *investment* has higher expenses because of the death benefits purchased and policy costs, the variable life proceeds are not subject to any year-to-year taxes or capital gain taxes upon the estate owner's demise.
- The same three alternative investment strategies used for family protection/investing were used for this wealth-transfer comparison (index, balanced, and actively traded funds on a *buy-and-hold* basis).
- The same three alternative average investment returns used for family protection/investing were used for the wealth-transfer comparison (8%, 10% and 12% for the equity funds and 6.16%, 7.7% and 9.24% for the balanced fund).