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Insurance Products and the Needs of the 50-Something Individual

By Peter Katt

In previous columns, I have written about the life insurance needs of *sixtysomething* individuals with estate planning opportunities and *thirtysomething* individuals with primarily family protection needs. This column will focus on the potential insurance needs of *fiftysomething* individuals.

From a financial point-of-view, many individuals are involved with the financial needs of their children during their 20s, 30s and 40s. In their 50s, these individuals may find that their financial responsibilities have significantly lightened and their income has substantially increased. For many, the most significant asset accumulation period begins in their 50s. But it is also during this period that income taxes will become more onerous because the family's income is up while the number of dependents is down. Therefore, tax-deferred investing becomes more relevant.

There are various tax-deferred investment vehicles that individuals can turn to, including IRAs and other pension-related investments, and, of course, long-term stock holdings. However, this column focuses on insurance products, and there are two insurance-related products that can be useful as tax-deferred investment vehicles: permanent life insurance and deferred annuities. While neither should be the only holding in an individual's portfolio, they can provide benefits in certain situations.

Assessing Your Situation

Investors seeking tax-deferred asset accumulation need to examine their own situation and desires regarding the uses for their accumulated assets. Assets can be accumulated during peak earning years by investors who have already acquired significant wealth, say over $2.0 million, in order to maximize their distribution to heirs—what I would refer to as an *accumulate-distribute* pattern. Or, investors who haven't acquired as much wealth may wish to accumulate assets in order to consume them during retirement—an *accumulate-consume* pattern.

Permanent life insurance and deferred annuities are similar because their cash values grow tax-deferred, but they have important differences that should be understood as investors in their 50s assess their usefulness when they make their final asset accumulation push.

Life Insurance

Life insurance can be useful for wealthy individuals in their 50s who are seeking to accumulate for the sole purpose of distributing to their heirs (inter-generational transfers) because the policy's death benefits are entirely income tax–free, and if the policy is in an irrevocable trust they are also not subject to estate taxes. In previous columns, I have referred to this as wealth transfer life insurance, whose ideal design is to minimize the initial death benefits in order to maximize the long-term values, thereby resembling an investment rather than risk insurance. The brief case study of Michael and Janet Miller, below, will provide an example of using life insurance to accumulate for inter-generational wealth transfers.

Life insurance can also be used to accumulate for the purpose of consumption (insureds using the cash values during retirement), again using the same design of minimum initial death benefits. This design will maximize the accumulation of tax-deferred cash value that can be withdrawn during retirement. (It is important that life insurance used to *accumulate-consume* avoid being classified as a modified endowment contract.) In contrast to deferred annuities, withdrawals from life insurance policies are income tax–free until withdrawals exceed cumulative premiums paid. Further, unlike deferred annuities, life insurance withdrawals aren't subject to tax penalties if made prior to the insured's age 59½. However, life insurance used to accumu-

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late cash value for the later enjoyment of the insured should be employed only if the policy's death benefits are objectively needed for a risk management purpose; otherwise, deferred annuities are probably a better choice because they don't have the higher costs associated with life insurance policies.

Deferred Annuities

Deferred annuities are useful for individuals who are not interested in distributing assets to heirs or protecting their spouse during this final accumulation stage. This type of *fiftysomething* individual is likely to be single with no immediate heirs, or the spouse or heirs don't depend on the individual for financial assistance. Deferred annuities allow for a larger build up of cash value than life insurance because there is no cost for death benefit protection. Deferred annuities grow tax-deferred. A deferred annuity can be held until the death of the annuitant, at which time the gain is taxable, or withdrawals can be made by the annuitant. Withdrawals are taxed on an interest-first basis, and if made prior to age 59½, there are penalty taxes. These characteristics, by the way, make deferred annuities less attractive for younger investors seeking tax-deferred accumulations. The final option is that the deferred annuity can be annuitized, paying the annuitant a guaranteed income for life. This income can be for the life of the annuitant only, or it can also provide a survivor's benefit. If a survivor's benefit is selected, the amount of income—compared to life-only income—is lower.

The appropriate uses of life insurance and deferred annuities, for tax-deferred accumulations, might be understood better by presenting several brief and somewhat simplified case studies.

Michael and Janet Miller

Michael and Janet Miller are both 52. Michael is a neonatologist and Janet is an attorney. Their two children are out of the house and pretty much on their own. They have accumulated $2.5 million in invested assets and Janet will inherit another $1.0 million, probably in the next decade. They believe it is a good time to begin balancing their asset accumulation with the longer view of distributing assets to their children in the most tax-wise manner possible. Michael and Janet decide on an annual budget of $20,000 for this *wealth transfer* asset accumulation plan. They plan on continuing this $20,000 for 13 years, when they both intend to retire, then stop the funding. Because of their current net worth, the Millers decide to transfer the $20,000 to an irrevocable trust so it isn't in their estates and therefore won't be subject to estate taxes.

Given the Millers desired pattern of *accumulate-distribute,* survivorship life insurance is ideal, using the minimum initial death benefits ($335,000) for the $20,000 premiums paid for 13 years. Based on current pricing conditions, a low-load universal life survivorship policy is projected to provide a $1,921,000 death benefit for their children at their joint life expectancy (38 years). This benefit is entirely free of income taxes (both during accumulation and at distribution) and because it is in an irrevocable trust it also isn't subject to estate taxes. This represents a projected net aftertax rate of return of 6.4% (equivalent to a 10.7% before-tax return, assuming a 40% marginal bracket). In contrast, a deferred annuity is not available in a survivorship form (it is only available in single-life form), and the cash value gain is fully subject to income taxes at the death of the annuitant. Using the same yield for a deferred annuity as I did for the survivorship universal life policy, its net aftertax value is $1,231,000, or a rate of return of only 4.9% in 38 years. When wealthy individuals in their 50s wish to *accumulate-distribute*, a survivorship life insurance policy designed for maximum wealth transfer is clearly a better choice than deferred annuities. I would prefer universal life over whole life for its greater flexibility. Variable universal life could also be used if the investors wished to have the policy's cash value more aggressively invested, by selecting from a group of mutual funds.

John and Joan Brody

John and Joan Brody are both 54 with three children now on their own. John is a mid-level production manager with a pharmaceutical company and Joan is a school teacher. They have a combined income of $125,000 and invested assets of only $30,000 because they sacrificed in order to provide their children with excellent educations. John and Joan each have reasonable pension plans and Social Security, but they want to supplement these so they can do some extensive traveling during retirement. By continuing their sacrifices, they can invest $3,500 per month ($42,000 annually) until taking early retirement in eight years. Having the additional time free of working is more important to them than the higher pension they could have if they wait until 65 to retire.

John and Joan believe they should do this investing in a tax-deferred manner. They aren't interested in the volatility inherent with equity investments, so they decide to consider universal life and deferred annuities, both of which are supported primarily with bond yields. [While John and Joan are willing to live with the prospects of no growth inherent in any vehicle that lacks stock investments, other investors who do not want to give up growth for certainty may want to consider variable annuities, which offer stock investment options. For more on variable annuities, see my column, "Be Aware of Volatility When Using Variable Life as an Investment Option" in the January 1994 issue.] The choice between the two is difficult because although the life insurance route provides needed death benefit protection for the survivor, both during the accumulation and consumption stages, the deferred annuity will provide about 11% better income in retirement (a projected annual aftertax difference of $23,400 with life insurance and $26,000 with a de-

ferred fixed annuity) because the insurance costs are absent from the deferred annuity. Therefore, it is decided to use half of their $42,000 annual investment budget to fund deferred annuities and half to fund life insurance policies on each of their lives. Because John's income contribution is larger, a larger $250,000 policy with premiums of $15,000 is purchased insuring his life and a $125,000 policy with premiums of $6,000 is purchased insuring Joan's life, leaving $21,000 annually to be invested in deferred annuities, again split between buying some with John as the annuitant and some with Joan as annuitant.

Based on current pricing assumptions, the Brodys will accumulate sufficient values in their deferred annuities and life insurance policies to receive aftertax benefits of about $25,000 each year, beginning in eight years when they are both 62. Specifically, they can annuitize (convert to monthly payments for the rest of their lives) the value of the deferred annuities. A portion of the payment is a tax-free return of principal and a portion is taxable gain. Using current annuity rates and appropriate exclusion ratios, I calculate that the aftertax benefits are about $13,200 per year. This is based on also providing a 100% survivor's benefit. That is, the Brodys will reduce their individual benefits (9% for Joan's benefit and 19% for John's benefit) in order for the survivor to continue with the full benefits.

Using current pricing assumptions, I calculate that the universal life insurance policies would have the following benefits when they are both 62, their retirement year: John's cash value is projected to be $142,720 with a death benefit of $382,543, which John will reduce to $241,700 when withdrawals begin in order to minimize the insurance costs that are no longer as relevant; and Joan's cash value is $57,600 with a death benefit of $179,100, which is reduced to $121,600. Using these cash values for retirement income, I calculate they will be able to withdraw about $11,800 annually for 14 years as a tax-free return of principal, then $18,200 that is taxable, netting the Brodys about $11,800 until they are into their 90s. (It is possible that some withdrawals might be treated as policy loans, depending on policy loan interest rates and tax laws at the time, but I believe it is unwise to plan on having a steady stream of *tax-free* income from the universal life policies.)

After the first spouse's death, the survivor will continue to receive full annuity payments and a death benefit from the decedent spouse's life insurance. This death benefit should offset the withdrawals that the decedent had been making from the life insurance policy insuring their life. Therefore, this tax-deferred approach to *accumulate-consume* should leave the surviving spouse with about the same income as when they were both alive.

Based on current pricing assumptions it appears that the Brodys can invest $42,000 annually, split between universal life and deferred annuities, for eight years, then begin receiving an aftertax annual income of about $25,000 for life, regardless of when the first death occurs. The before-tax equivalent rate of return at the second death is approximately 5.6% if the second death occurs 15 years after retirement begins, 6.6% in 20 years, 7.0% in 25 years (about their joint life expectancy), 7.5% in 30 years and 7.3% in 33 years. (Since there are no residual annuity benefits at the second death the return is lower if they both die before life expectancy, but using annuities for a portion of this plan increases the annual income by about 5.5%, so this potential downside is probably worth better benefits long-term if they live to their life expectancy. Also, the overall returns are lower than might be expected if invested more conventionally because of the security built into this scenario—the survivor's income from the life insurance and annuities.)

The Brodys have sacrificed to provide each of their three children with excellent educations, and now they want to accumulate during this final push before retirement. Their goal is to maximize their surplus retirement income for the pleasures of travel without taking on too much risk, while protecting each other in the event one of them dies prematurely. The combination of universal life and deferred annuities is an appropriate way to accomplish these goals.

Maxine Potter

Maxine is a 53-year-old political science professor in excellent health who enjoys golf, tennis, and hiking. She has been at the same university for 20 years. Her husband died when she was 28. Maxine has no children. Her only sibling has no financial concerns. Maxine has written two books that have been financially successful. This has allowed her to now have a net surplus from her professor's salary that can be invested. Although Maxine loves scholarship and writing, the actual teaching of students has become less enjoyable. Maxine decides to plan on retirement in nine years, at age 62, rather than waiting until 65, and moving to Arizona. Early retirement will reduce her retirement income so she wants to supplement it.

Maxine decides to invest her surplus salary in a deferred annuity, then in nine years when she retires, consider whether it is best to withdraw funds, take an income for life, or a combination. In researching insurance companies for the purchase of this annuity, she concentrates on their financial strength ratings and the actual interest they have credited over the past 15 years, not the current interest being offered. This is a wise strategy since some companies exaggerate their current rate in order to get the business, but aren't able to continue such sales-driven rates.

Maxine is able to invest $1,200 per month into her deferred annuity. At current bond yield levels (the primary asset supporting deferred annuities), she will accumulate a tax-deferred cash value of $176,270 in nine years. Upon early retirement Maxine might decide to withdraw funds from the annuities in order to support herself for three years until reaching 65, when her pension and Social Security stipends would be higher than if initiated at age 62. Withdrawals from the annuities are taxed

on an interest first basis, so the first $46,670 would be taxable, then most of her subsequent withdrawals would be tax-free. For example, Maxine could withdraw $36,000 annually for three years, netting about $27,000 the first year, $32,250 the second year, and $36,000 the third year. This pattern of withdrawals would leave her with an annuity balance of about $90,000 that could either be annuitized at that time, providing her with an annual aftertax income of about $6,900 for life, or retain the balance, that would grow tax-deferred, for special needs in the future. Maxine's other option upon reaching 62 would be to take a lifetime income from her annuity. Again using current bond yield levels, she could receive about $12,800 aftertax annually for life. (Taking a life-only benefit, rather than a benefit with residual value in the event of Maxine's early death, increases her benefit by about 9%. This is a reasonable risk for Maxine to take since she has no one who is financially dependent on her.)

Maxine's desire to retire early motivated her to begin an investment program to supplement her income in retirement or to use the proceeds to bridge the gap from age 62 to 65. A deferred annuity will allow her to accumulate funds tax-deferred during her highest earning period, investing in less volatile fixed-income instruments [again, however, she is giving up potential growth for stability, and could consider variable annuities if she doesn't want to make the trade-off). Her decision to either take withdrawals from the annuity in order to postpone taking pension and Social Security benefits for three years, or to begin taking a lifetime income at age 62 is a decision that is best made at the time. Her deferred annuity is appropriate because the earnings are tax-deferred, provide flexibility at retirement, and will pay a benefit that Maxine can't outlive.

Conclusion

After major financial responsibilities have ended and income is at its highest, asset accumulation might best be accomplished on a tax-deferred basis. Life insurance and deferred annuities are two possible tax-deferred asset accumulation methods to be considered, but attention should be paid to the specific situation and goals to determine whether life insurance, deferred annuity, or a combination is the best solution.