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Refresher on Key Insurance Concepts for Financial Planners

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This column provides practical commentary on insurance products, issues, and planning that I frequently encounter. Considering the questions I often receive from CFP® practitioners, I hope advisers can use this information as a quick check to see whether proposals encountered are even sensible. I have written about each item in some depth over the years, and those more-detailed explorations can be found at the *Journal's* site (www.FPAnet.org/Journal) or mine (http://www.peterkatt.com/).

Annuity (Deferred): An asset that defers recognizing income until the annuity matures. It can be continued and transferred to a spouse at death without tax consequence. Ultimately, it can be transferred to children, and they begin receiving income at their life expectancies with appropriate taxes paid. Or clients can exchange it for an income annuity at retirement to receive income for life. An astute planner should use deferred annuities to absorb taxable income or otherwise unused cost basis from life insurance being terminated because tax-neutral exchanges are allowed. I recommend using the fixed annuity instead of variable or index annuity. This usually isn't an appropriate asset for the wealthy because they have no need to convert to an income annuity and need greater flexibility in asset distributions to match up with estate planning strategies.

Annuity (Income): Provides income for life with a specified, certain period of say, 10 years, if this is desired. Usually a portion of the income payment is taxable with the remainder tax-free return of principal. In combination with deferred annuities for early accumulation, these provide very tax-wise planning when qualified plans have been maxed out.

Term Life Insurance: The primary life insurance risk asset for most families, usually purchased as 10-, 15-, 20-, 25-, or 30-year level term. Most clients are underinsured with term. Considering how inexpensive it is and the vulnerability of families when primary income earners die, buy a lot of term. Term is also used for business buy-sell funding. Also, term can be used for short-term estate tax liquidity when estate assets will be liquidated. Finally, most term can be converted to permanent insurance without proof of insurability. This can be a very valuable right in the correct circumstances.

Participating Whole Life (PWL): Is sold by the few remaining mutual life insurance companies. It has two excellent uses that feature death benefits that will increase significantly over time as dividends are earned. The first use is for 30- and 40-something high earning professionals to accumulate cash value on a tax-deferred basis and add to their family protection life insurance. Later cash values can be withdrawn tax-free (up to cost basis) for education purposes, to supplement retirement, or whatever. The residual policy will continue and provide an inheritance for children. The other use is for the wealthy who don't have an estate tax liquidity problem. PWL is an excellent wealth transfer asset. Gifts are made to an irrevocable trust and invested in the PWL. The proceeds are income-tax free. Do not use PWL when level death benefits are needed because it lacks premium flexibility.

Universal Life (Current Assumption): Current assumption (also known as market-priced) refers to policy performance that will change as the interest crediting rate changes. In most cases this will affect the target premiums. Universal life (UL) should be used for level death benefits with target premiums adjusted as the crediting rates change. Target premiums should also be adjusted if there is a significant change in the insured's health because this will impact mortality—or timing on the maturity of the policy. UL can be used for long-term buy-sell funding, permanent family protection, and, most commonly, estate tax liquidity. Current assumption UL has robust cash values and will do well when interest rates are high on a sustained basis.

Universal Life (Guaranteed): ULG has guaranteed premiums and death benefits. These policies usually have low to zero cash values. They are used for the same reason current assumption UL is used. The advantage of ULG is the guarantees—no moving parts. What you see is what you get. The concern is the too-good-to-be-true aspect. Considering the floor-dragging fixed-income rates that are promised for several more years, I am concerned about insolvency. At the very least, clients should be given the choice of current assumption UL and ULG with appropriate cautionary caveats. A recent case has the current assumption premium at $40,000 a year (and almost certain to go up) with the ULG premium at $10,000. I am fine with clients taking the ULG as long as they understand the risk needle is higher.

Universal Life (Indexed): IUL claims to provide crediting based on various stock indices. I am skeptical that the actual performance will be anything like this. My concern is that IUL is mostly an illustration advantage over current assumption UL and not real. The few experiences I have with being able to review actual performance of IULs supports my concern. When I write such things, the IUL sellers get very angry with me. I repeat here what I have asked them for: send me redacted annual statements for at least seven years showing the performance of the surrender value that is equal to the appropriate indices, and I will provide my mea culpa. I have seen one significant potential problem with IUL when it is combined with premium financing (discussed below). The higher illustrated IUL rates make it appear that the policy's cash values can cover the loan's collateral. I'm betting they won't.

Variable Life (VL): A permanent policy whose cash value investment is controlled by the policy owner by selecting various bond and equity sub-accounts. Except for (very) special situations, I don't recommend VL because the investment volatility's effect on policies in the medium and long term is simply not understood by buyers, agents who sell them, or companies that provide VL. Many of these policies implode because the market losses overwhelm the market gains within the VL policy. This often causes these VL policies to be terminated. The only VL I accept is when death benefits are as low as possible, premiums are as high as possible, and its design allows for death benefits to rise or fall in response to equity gains and losses.

Disability Income Insurance (DI): A risk management asset that protects against financial disaster when earners

lose income because of a disability. Many executives have group long-term disability coverage that often covers up to 60 percent of pre-disability income for specified periods, often to age 65. Independent professionals (physicians, dentists, attorneys, etc.) should have individual DI policies. All DI policies should have residual coverage that provides partial benefits when a disability isn't total but income is affected. Personal policies have cost-of-living riders. They are expensive but well worth it if you become disabled. Ninety-day waiting periods are generally the most efficient cost/benefit design. A key to DI planning is not deducting the premiums; if premiums are deducted the benefits are taxable. If not deducted, the benefits are free of income taxes. This is a bit tricky for group programs that are paid for and deducted by employers. You may be able to work with HR to receive 1099s in the amount of the premiums and pay taxes on this amount so benefits are tax free.

Long-Term Care: A risk management asset that protects against the costs of needing care during old age. LTC insurance doesn't cover medical or critical care situations. LTC workers assist insureds with the difficulties of daily living activities. Many plans pay a stipend, so it doesn't matter whether the care is received in an institution or at home. Under the right circumstances, LTC is a bargain. But some cautionary thoughts. First, LTC premiums have risen considerably—and may continue to rise. This causes LTC owners to terminate their policies. A number of companies have gotten out of this market and more will. I believe companies didn't think through LTC very well and now regret opening up this market. This could mean tough claim approvals. This happened with DI in the 1980s and 1990s. I have found that some clients have a special fear of funding long-term care and are motivated to buy the insurance regardless of cautions. Clients without the fear generally don't buy it.

Premium Financing: In order to make selling life insurance easier some agents propose financing premiums and interest costs. I have never seen this work if insureds live near life expectancy. The loan costs overwhelm the policy's cash value collateral and personal collateral is required. In a recent case, a healthy 79-year-old is on the cusp of having to put up significant collateral and within seven years of having the entire program collapse, wiping out his entire net worth of $25 million. The cost of terminating such a policy is paying for all the free life insurance clients have had. If they don't die soon enough the program collapses. Premium financing is a six of one, half-dozen of another scenario when the interest is paid out of pocket, and there are unique situations when this might be desired. But financing premiums and interest should never be used.

Life Settlement: The sale of a policy when an insured's health has deteriorated and the policy owner is desperate for cash. Other than this situation, a policy won't sell or shouldn't be sold. Selling a policy in the life settlement market should only be considered for the situation described above.