

Investment aspects of life insurance

Almost everyone believes that he or she needs life insurance to provide cash for his or her family, business partners and charitable endeavors that he or she values. But what people don't always consider is the *utility* of life insurance as an investment vehicle during one's lifetime.

Overview: cash value policies

In general, there are two types of insurance. *Term* life insurance is pure insurance and provides only protection—in the form of a cash payment to a beneficiary upon your death. *Cash value* life insurance (sometimes referred to as *permanent* life insurance) has the added bonus of the tax-free buildup of accessible wealth. With these policies the premiums that you pay cover the insurance company's overhead and the cost of insuring the lives of the company's customers, with the balance going into the policy's cash value.

Because of initial selling costs, cash values build up very slowly at first but accelerate in later years to provide competitive long-term yields. There are various types of policies, differing in how the death benefit is fixed, how the cash value is invested and how the policy owner can utilize the cash value.

General account policies

In *whole life* insurance the premium is fixed and calculated to be paid until a given age. (When cash value is equal to the death benefit, the policy is paid up, and no further premiums are required.) Your cash value is placed in the insurance company's general account, which, by regulation, is invested quite conservatively.

The insurance company guarantees a minimum rate of return and pays dividends in addition. You can take dividends in cash, add them to your tax-deferred investment and use them to reduce your premium or to buy small "paid-up" additions to your policy, boosting the total death benefit. The cash value is available through tax-free loans, which, as long as not repaid, reduce the death benefit. Dividends generally may be withdrawn tax free.

Universal life insurance involves a general account investment in which interest is credited at prevailing rates with a guaranteed minimum. You choose, within limits, how much in premiums to pay, and the death benefit varies with your results.

Paying the target premium proposed by an insurance agent guarantees that coverage at the desired level will last for life. Paying more than the amount proposed builds up additional tax-sheltered value. Paying much less, however, may require you to increase premiums in later years to keep the cash value from being exhausted by policy expenses and, as a result, the policy lapsing.

With a universal policy you choose how your cash benefit is applied. In Option A (also referred to as Option 1), cash value is applied to the death benefit, reducing the insurance component over time. With Option B (or Option 2), the insurance amount remains fixed, and the cash value increases the death benefit, providing a substantial inflation hedge. You can withdraw money from the cash value tax free up to the cost basis, but you should be careful to leave enough to prevent the policy's collapse.

The risk with both types of this insurance is that interest rates may decline, and the insurance company may not produce sufficient returns in its general account. Companies' failure to meet legal capitalization standards will bring in regulators to slash the cash values of policy holders.

Variable policies

Variable universal life insurance offers all the premium and death benefit flexibility of universal life while cash value builds up in investment accounts managed by the policy holder.

You are typically given a choice from a universe of accounts, similar to mutual funds, that invest in stocks, bonds, and money market and other funds. You may vary your premium within limits, but it's important not to exceed a government-mandated "seven-pay" test during the policy's first seven years so that the policy will not be classified as a "Modified Endowment Contract." Such a designation would prevent tax-free loans and withdrawals.

Because the cash value of a variable policy is subject to market conditions, it is possible for it to fail. To "bullet proof" a policy, consider keeping three years' worth of policy expenses in the company's guaranteed interest account.

The risks in variable policies are market risks. History tells us that the markets, over time, tend to outperform the guaranteed returns achieved by insurance company general accounts. This is especially true with the added power of tax-deferred compounding. Equally

important, variable policy cash values are not subject to the fortunes of the insurance company.

As you can see from this very brief overview, determining the type of insurance policy that best fits your needs requires serious consideration. In addition, there are issues of how to structure the ownership of your policy. We recommend, therefore, that before making decisions, you consult your advisors.

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Any developments occurring after January 1, 2008, are not reflected in this article.