

Insurance in Retirement

By Ben Baldwin, Jr.

Retirement Income from Variable Universal Life—The Good, the Bad and the Alternatives



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The illustration for the VUL policy that I received in 1987, 20 years ago, showed that if I put \$10,000 per year into the policy I could take out \$20,000 per year income tax free *via* withdrawals, to policy cost basis, followed by policy loans from the policy from my current age 65 until I am age 85! Isn't that great ... I am about to start.

Let's examine the risks and the wisdom of this plan. How likely is it that this variable universal life (VUL) policy is going to be able to deliver \$20,000 per year for 20 years? Income tax-free cost basis withdrawals will be exhausted in 10 years. Policy loans will have to be utilized for the next 10 years so the specific contract provisions, concerning policy loans and their cost, becomes extremely important for those relying on this income tax-free income stream.

Any investment-related life insurance policy can be used to accumulate capital that can then be used for any living benefits purpose, including using it to provide retirement income. The advisor would tailor the plan to the individual client's needs, desires and risk tolerance in order to make it an eminently suitable strategy. We will focus on variable universal life insurance as a financial tool that we can use and adapt when the concern of a premature death gives way to a concern about adequate retirement income during a long life, as well as the desire to leave a financial legacy. Variable universal life (VUL) has been chosen because it provides an opportunity for diversification and also gives the policy owner the most control, as well as the responsibility to adjust the contract to retirement needs.

We will then focus on the advantages and disadvantages of using the same VUL contract, if



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needed, as a retirement distribution vehicle or whether it would be more prudent to exchange the life insurance policy into any one of the many annuity strategies that are becoming more and more consumer-friendly.

Retirement Income Distributions from Variable Universal Life Insurance

Way back at the inception of this VUL policy in 1987, the young agent presented a VUL illustration for a \$400,000 policy with annual premiums of \$10,000 payable until retirement at age 65. At a time when many were using the maximum allowable interest rate assumption of 12 percent, this agent used a relatively conservative interest rate assumption of nine percent. The illustration indicated that these specifications would then allow the withdrawal and borrowing from the policy of income tax-free retirement income of \$20,000 per year from 2007 through 2027. The policy owner, now that it is 2007, is asking an older and grayer advisor whether this is a prudent strategy.

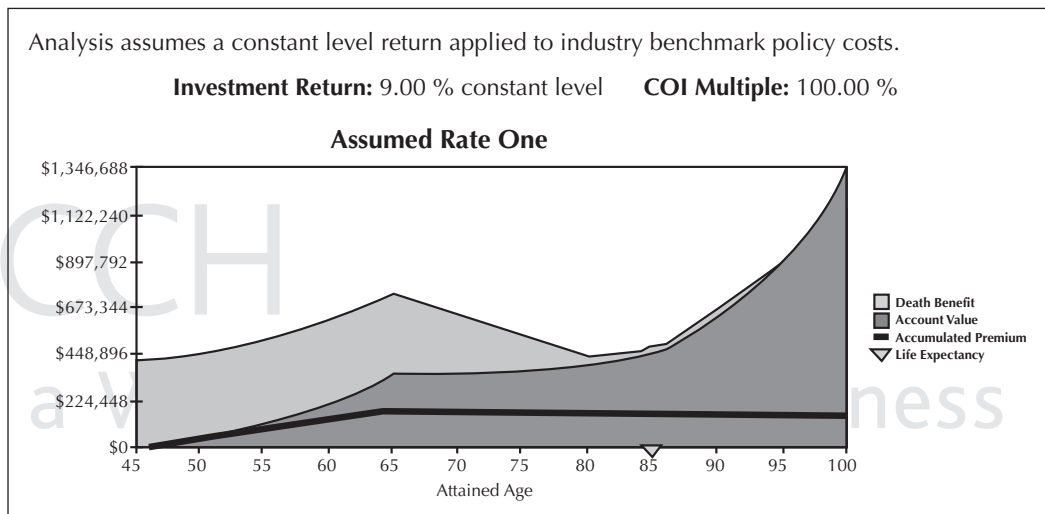
Monte Carlo Testing of Life Insurance Illustrations

The older and wiser financial advisor is using the Monte Carlo software provided by Financial Profiles, Inc. called *Insurance Insight* to check on the 1987 illustration run at an assumed nine percent average rate of return. The advantage of using a Monte Carlo simulator is that it dramatically communicates that we certainly do not know what will happen but we need to know how likely a positive outcome will be if \$20,000 per year is withdrawn from the policy.

The inputs are that we have a \$400,000 VUL policy, on the life of a 45-year-old healthy male,

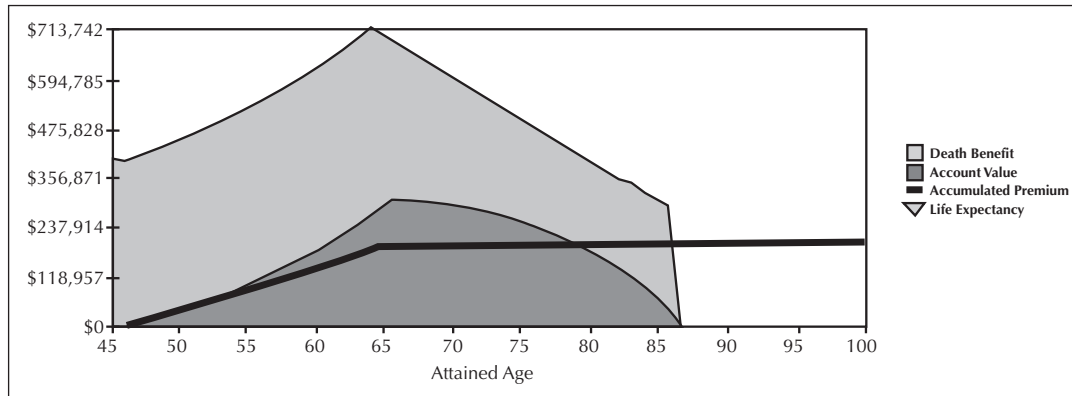
and assume that a \$10,000 per year premium will be paid for 20 years. Nine percent is the assumed average rate of return and the initial death benefit design that maintains the \$400,000 insurance company amount at risk during the first 20 funding years, which would provide a death benefit that would be equal to the \$400,000 plus whatever account value has accumulated on the date of death. This is called death benefit Option B or 2. The *Insurance Insight* diagram (Figure 1) of this illustration shows why the young agent was led to believe that the retirement income strategy would not only work, but would also provide about a \$400,000 legacy for the beneficiaries.

Figure 1. VUL at 9% Average Rate of Return



It is easy to see why the young agent was convinced by the insurance company provided illustration that the VUL policy could provide the \$20,000 per year retirement income distribution with money to spare. The linear illustration indicates success but there is no such thing as a long-term linear return in the diversified portfolio of subaccounts in a VUL. Testing with identical inputs except lowering the interest rate assumption from nine percent to eight percent makes the diagram look like Figure 2.

You will note that the plan fails if our insured lives beyond age 86. To prevent failure, the policy owner could maintain the \$400,000 death benefit by paying premium into the policy starting at about \$24,000 per year, and then rapidly increasing that premium as he got older. Alternatively, he could let the policy terminate and the insurance company would send him an IRS Form 1099 reporting the \$200,000 of gain he had taken from the policy over the good income

Figure 2. VUL at 8 Percent Assumed Average Rate of Return

only other choice in this software is 100 percent large cap), the software indicates that this retirement income strategy has a fifty-fifty chance of success. Most retirees will not find that chance for success very comforting. The failures illustrated between

years and pay ordinary income tax on that amount. You also will observe that the capital in the policy is decreasing over the retirement years, which is not conducive to a sanguine retirement. But, of course, neither of these linear presentations is anywhere near correct in our nonlinear world.

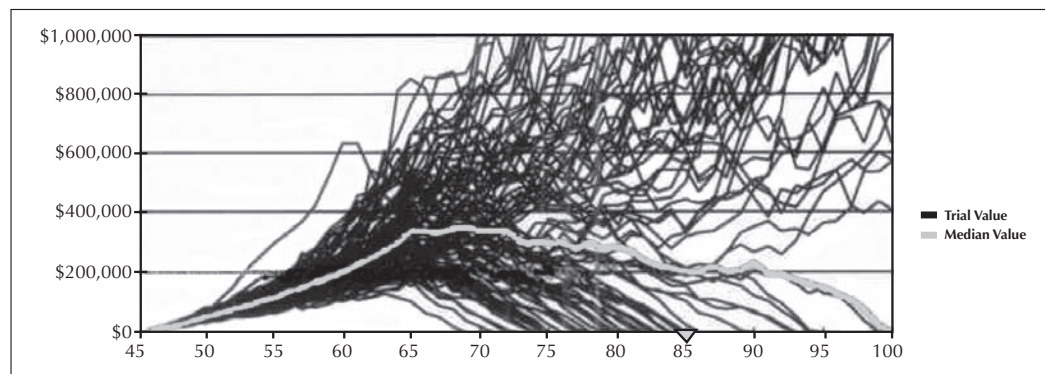
Consider what would have occurred if someone was involved in this retirement income strategy in 2000, 2001 and 2002. Each withdrawal would reduce capital within the contract and, in an Option 1 (Option A) Death Benefit policy, the cost of insurance COIs would increase the very next month to cover the cost of the insurance company's increased amount at risk. The dynamics in the withdrawals to cost basis, followed by loans to generate consistent monthly income, are that an increasing amount at risk causes increasing COIs, based upon the age of an increasingly older person. This scenario would be exacerbated by negative market performance (think 2000, 2001, 2002) causing even a greater amount at risk while simultaneously drawing down even more investment units to maintain the income flow. The triple hit to policy capital of continuing withdrawals, market declines and increasing COIs could easily destroy a policy.

Utilizing the Monte Carlo engine in the *Insurance Insight* software and testing the retirement income scenario 500 times provides a result that looks like Figure 3. Using a VUL investment portfolio of 60 percent large cap and 40 percent Treasury bill, (the

ages 70 and 85 would be very stressful for anyone.

So something that sounds so good and looks possible using linear illustrations can run into serious problems in the real world. The key to successfully using income tax-free extractions of capital from a VUL contract is careful monitoring and avoiding excessive reliance on the income stream so that withdrawals can be suspended during down markets. We have to make sure that sufficient capital remains in the contract at least to pay the potential income tax liability if the contract must be terminated prior to death. It is always preferable for the policy to be in force when the insured eventually dies.

Some insurance companies are making guaranteed minimum living benefit riders available in their VUL policies fashioned after the living benefit riders in annuities. Insurance companies recognize the risks so these riders are not provided free of charge nor are they without restrictions on what the policy owner can and cannot do with the contract. Actions outside of those required by the rider voids these guarantees. These costs and restrictions serve to make us aware of how difficult it is to successfully maintain these guarantees. For example, the Guaranteed Minimum

Figure 3. Monte Carlo Testing of the VUL Retirement Income Plan

Withdrawal Benefit (GMWB) provided by one life insurance company is defined as follows.

The Guaranteed Minimum Withdrawal Benefit (GMWB) feature guarantees a minimum income benefit regardless of investment performance, subject to an annual withdrawal limit and a waiting period before withdrawals are permitted of the *later* of the tenth policy anniversary and the policy anniversary following the insured's fifty-fifth birthday.

1. The GMWB is available only when the policy is purchased.
2. The GMWB is irrevocable once in force.
3. The maximum cost of the GMWB is 1.5 percent, charged monthly at 0.125 percent. The current annual cost of the GMWB is 0.7 percent. The charge is in addition to any M&E charges and fund management expenses.
4. The policy has a fixed required annual premium for the first four years and is flexible thereafter.
5. All policies are issued on Death Benefit Option B, which may not be changed until after the fourth year.
6. If the GMWB is purchased, an asset allocation or strategic program (monthly mandatory rebalancing) provided by the contract must be elected. Electing out of the asset allocation or strategic programs will cause the GMWB to terminate without value.
7. COIs and Administrative monthly deductions will be deducted from the sub accounts on a pro rata basis.
8. Policy owner bears all of the investment risk and, using the company mandated asset allocation or strategic program does not protect against loss.
9. Loans and withdrawals are limited prior to the later of the tenth policy anniversary and the policy anniversary following the insured's fifty-fifth birthday.
10. Excess loans and withdrawals prior to the later of the tenth policy anniversary and the policy anniversary following the insured's fifty-fifth birthday cause a recalculation of the GMWB limit.
11. The GMWB contains a feature that maintains a minimum policy value and death benefit in order to protect the policy prior to the death of the insured as long as the requirements are met. If this feature is required to be put into effect no further withdrawals will be allowed.

The complexity of providing a GMWB at the insurance company level would lead us to conclude that extracting 100 percent income tax-free income from

a VUL is very difficult and fraught with risk. Greed or need is the problem.

Using Life Insurance Capital to Buy an Annuity—The 1035 Exchange

Annuitization allows annuitants to recover income tax-free what they paid for the nonqualified annuity over the government provided life expectancy of the annuitant or annuitants. That often means that about 60 percent of the annuity income will be income tax-free until the total cost basis is recovered. So we would have to ask this retiree if the extra 40 percent of tax-free income from the life insurance policy is really all that valuable. Also, if Senate Bill S 1010 and House Bill 2205 become law, \$20,000 of annual annuity income could become income tax-free. This certainly would make dealing with all the hassle of trying to manage a VUL retirement income stream less attractive.

This couple should consider a 1035 tax-free exchange of their well-funded VUL contract into a joint and survivor immediate annuity with a 20 plus year guarantee of payments, even if they both die prior to that. Of course, this design will not serve everyone's purpose and any annuity could be tailored to their particular needs. This is just a place to start.

The idea of doing a 1035 tax-free exchange of old unneeded life insurance policies into an annuity is one we should consider for those requiring retirement income. The 1035 exchange moves the total cost basis of the life insurance policy into the annuity. That life insurance cost basis includes all the money that was spent to provide life insurance protection over all of those years. For example, if someone was about to buy an annuity with a \$50,000 check but also had an unneeded life insurance contract with a cash value of \$50,000 and a cost basis of \$100,000 we have the opportunity to put that higher cost basis into an annuity. Utilizing a 1035 exchange of the life insurance policy into the annuity would result in an annuity with an asset value of \$50,000 but with a cost basis of \$100,000. Our example would provide twice the income tax-free return of basis compared to the outright purchase. If the opportunity was available to 1035 exchange into a deferred annuity, which eventually appreciated to \$100,000, that additional \$50,000 of gain would not be subject to income

tax, as a result of the carry over of cost basis from the life insurance policy.

makes life insurance unique. In both life insurance and annuities, it is important to use their positive design features to accomplish a client's goals.

Conclusion

Life insurance can provide living benefits but it is the existence of the tax-advantaged death benefit that

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