



IUL AND WHOLE LIFE

Evaluating the Options
for Savings-Oriented
Life Insurance

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EVALUATING SAVINGS-ORIENTED LIFE INSURANCE

It has been said that all life insurance is the same. It is true that all life insurance policies fall under section 7702 of the Internal Revenue Service (IRS) tax code, defining a legitimate life insurance contract, and they all provide death benefit protection. Just like jeans are made of the same fabric, cars all have four wheels, and houses all have roofs; that is where the similarities end. Life insurance offers many different benefits, terms and features to coincide with your unique needs and objectives.

With increasing concern over stock market performance and the impact of tax-deferred saving, more Americans are turning to cash value life insurance as a way to potentially supplement their income in retirement,¹ as well as provide needed death benefit protection for their families or business. The two most common vehicles — dividend-paying whole life (WL) and indexed universal life (IUL) — both have strong advocates (and strong detractors) in the insurance and finance industry.

Many may be left wondering: Which product is a better choice for my situation?



¹ Typically via policy loans. Policy loans and withdrawals are not usually subject to income tax unless the policy is classified as a modified endowment contract (MEC) under IRC Section 7702A. Policy loans and withdrawals will reduce available cash values and death benefits and may cause the policy to lapse. Additional premium payments may be required to keep the policy in force. In the event of a lapse, outstanding policy loans in excess of unrecovered cost basis will be subject to ordinary income tax. Tax laws are subject to change; consult a tax professional about your personal situation.

While the appropriateness of any life insurance policy depends on factors personal to a given individual, there are some broad features on which we can evaluate WL and IUL — features that greatly impact your choice when using these products not only for the death benefit protection but also as savings vehicles. It's important to keep in mind that life insurance policies are subject to medical underwriting and, in some cases, financial underwriting. Life insurance products contain fees, such as mortality and expense charges, and may contain restrictions, such as surrender charges. Cash value life insurance policies need to be carefully managed to ensure they are sufficiently funded to remain in force. Of course, life insurance is just one component of your overall financial and legacy strategy.

PRODUCT GENESIS AND MECHANICS

Whole life has been a mainstay of the insurance industry for nearly 100 years, with its popularity waxing and waning depending on national mood and opportunities in the market. Whole life products work like this:

- A policyholder pays the insurance company a premium to initiate the policy.
- This annual premium is set to support a given death benefit under two assumptions: the maximum mortality and expense charges, and the minimum interest rate the company estimates it would credit in a "worst-case scenario."
- Over the course of the year, the insurance company's actuaries determine actual

experience and make adjustments to the initial premiums through the declaration of annual dividends.

- It is similar in concept to over-withholding for taxes every year and then getting a refund once your actual tax bill is known. Through dividends, policyholders can receive credit for the amount of premium overpayment initially charged.
- The cash value of the policy grows by these dividend interest credits.

Whole life was the primary cash value life insurance used in the U.S. for many years. Then, in the early 1980s, consumers began to demand several updates to the basic life insurance structure:

- Increased transparency
- Better separation of the pure death benefit component from the savings element
- Enhanced flexibility

Universal life insurance was developed in response to these consumer demands. Advocates of this new form of life insurance worked to modernize the traditional dividend-paying whole life structure. To meet continued consumer demand, in the late 1990s, a fixed indexed (or "indexed") version of universal life was developed to expand consumer choice for policy interest credits.

Indexed universal life products work like this:

- An annual premium is set to support a given death benefit. In many cases, IUL

policies are “overfunded,” meaning the annual premium is more than required to carry the death benefit. This allows additional cash value to accumulate in the policy.

- Interest credits are determined, typically annually, based on a defined formula tied to an outside index (for example, the S&P 500[®] Index²).
- Annual expense and mortality charges are established and charged each year.
- The policy states maximum expense and mortality charges and minimum credited interest rates, as required by regulation. Unlike whole life policies, which assume these maximum and minimum rates in the premium calculation, an IUL policy does not charge these rates upfront and then credit any difference. In IUL, these maximum and minimum rates serve as notice of what the insurance company could potentially use if future experience warrants adjustments.

PRODUCT EVALUATION

When evaluating whole life and IUL, it is important to consider five factors that have a significant ability to impact

consumer experience and value: rating, the balance between cash value and death benefit, interest crediting, maximum charges, and transparency.

Let’s look at each factor to see how it impacts each product’s use and the potential savings possibilities.

1. Financial Ratings of the Carrier

Any life insurance policy is, by its nature, a long-term financial instrument. Care should be taken to utilize sound, highly rated insurers.

- Regardless of policy type, companies with an AM Best rating in the “A” category are preferable.³
- Poorly rated companies bring additional risk to your financial strategy — regardless of whether whole life or IUL is being used.

2. Emphasis of Savings Component Versus Death Benefit Component

Today, a growing majority of whole life and IUL policyholders are using the policies for the twin needs of death benefit protection and cash value accumulation.



² The S&P 500[®] Index is a product of S&P Dow Jones Indices LLC or its affiliates. Indexed universal life is not a registered security or stock market investment and does not directly participate in any stock or equity investments or index. The index used is a price index and does not reflect dividends paid on the underlying stocks.

³ Independent rating services evaluate insurance company financial strength. The ratings relate to an insurance company’s ability to meet its claims and guarantees. The ratings do not apply to the safety or performance of any specific insurance product and are subject to change.



That's because cash value life insurance gives them the ability to accumulate funds tax-deferred while also delivering a death benefit to their heirs.

While many savers want death benefit protection, they do not want to sacrifice cash value growth for more protection than they need. In addition, the IRS has established a set of rules that specify the minimum death benefit component that will allow an insurance policy to qualify for tax-favored savings treatment.

If you choose to use cash value life insurance also as a savings vehicle, it's important to balance these two needs correctly. Both whole life and IUL can achieve this balance, if structured correctly.

- In whole life policies, when a dividend is declared, policyholders have a choice: The dividend can be used to increase the cash value, pay next year's premium or buy paid-up additions to the death benefit.
 - If a whole life policy is structured to use dividends for paid-up additions, the policy builds up a larger death

benefit at the expense of the savings component.

- If a whole life policy is structured to use dividends to pay next year's premium, the cash value growth will suffer, as it does not increase by both premiums and credited interest.
- If one of your goals is to maximize cash value growth — and this is a common priority for savers using cash value life insurance for supplemental retirement income — these whole life structures may not be the best choice for you.
- Conversely, many IUL policies are structured as "overfunded" policies, meaning more premium is paid than needed to support the death benefit. Additionally, IUL death benefits are often set at or near the IRS minimum.
 - This structure aims to maximize cash value growth while minimizing mortality charges, so more of the premium and interest credited remain in the account value.



3. Interest Crediting

How interest is credited to the policy is one of the more important features. This is what distinguishes cash value life insurance from other products and what makes it possible to use either whole life and IUL for supplemental retirement income.

The biggest difference between the two products is how interest is credited to the policy. In a whole life policy, credited interest is tied to internal carrier decisions. In an IUL policy, credited interest is tied to the movement of an external index.

Whole life credits interest through dividends or declared interest rates for a policy's cash value. Under whole life, the insurer's overall investment experience is embedded in the dividend scale.

- In years when experience is good, dividends are favorably impacted and may be higher.
- In years when results are not as good (for example, when interest rates are low or credit losses are high), dividends are negatively impacted and may be lower.
- Whether market experience is positive or poor, interest credited in a whole life insurance policy is tied to internal carrier decisions; a policyholder must wait for the company's dividend decision to know how much their policy has earned.

Perhaps the biggest innovation IUL introduced to the marketplace is the use of an outside index to calculate the interest credited to the policy. For example, the S&P 500® Index is often used, subject to an annual floor and cap.

Indexing gives policyholders the ability to potentially benefit from market index gains while being protected from market losses. It's designed to deliver growth potential and protection.

- When the market is up on the policy anniversary, policyholders can receive interest based on the chosen index's growth, up to limits set by the company referred to as caps, spreads and/or participation rates.
- Because most IUL policy indexes have "floors" of zero, the credited rate can never be less than zero. The interest credited, then, is always zero or positive.
- Since there is a floor of zero interest credited, policyholders never give back past credits through negative credited interest, although they may still experience deductions from their cash value for additional riders or benefits purchased.
- Because the index is reset every year, policyholders do not need to recover from the market's previous high in







order to get future credits. This provides the opportunity for attractive interest crediting, even when the stock market is volatile.

- IUL policyholders can determine how much interest will be credited to their policies by understanding the index calculation used and following their chosen index value. They do not need to wait for the insurance carrier to calculate their interest.

The way interest is credited to whole life and IUL policies also impacts another key feature: how you can access funds from the policy through policy loans.

- In whole life policies, policyholders are limited in the types of loans they can choose. Additionally, it's more difficult to analyze if a policyholder is earning a positive or negative spread on the loan, as the interest is embedded in the dividend and not transparent.
- In IUL policies, policyholders have more choice in loan type, including the option for "wash" or "net-zero cost" loans. Policyholders have the flexibility to switch between loan types as needed. Finally, the interest spread on loans — if any — is transparent because it is tied to index performance.



4. Transparency

You will want — and deserve — to know how interest is credited to your policy and how expenses and mortality charges are deducted. You can review your policy illustration to readily understand how the policy's credits and debits work.

This is a feature that varies widely between whole life and IUL, with IUL proving to be more transparent in this regard.

- Under whole life, credits and charges are included in the dividend calculation and are not itemized separately.
- Under IUL, potential credits and charges are explicitly explained in the policy illustration.

Policyholders can obtain a more transparent accounting of interest credits, expenses and mortality charges in IUL.

This is an important distinction, as transparent expense loadings are how you can determine if a policy's costs are attractive compared to cash value growth. You deserve to know if your policy is a good value for the benefits it delivers.

Under whole life, policyholders cannot determine expense charges independently, as they are included in the dividend scale and the premiums initially charged.

- This makes it more challenging in a whole life policy to understand the impact of the expenses being charged against the policy on the policy's growth.

Under IUL, anticipated expense charges are detailed in the illustration.

- This makes it possible to demonstrate not only the annual expense charges, but, more importantly, how these expenses relate to assumed average cash value growth over long periods of time.
- You and your financial professional can evaluate how mortality and expense charges impact cash value growth — and answer the important question: Is this policy a good value?

5. Maximum Expenses and Mortality Charges

Maximum expenses and mortality charges (the highest amounts a given insurance contract can legally charge) are an important part of policy structure, as they provide the "worst-case scenario" a policyholder may experience. As mentioned in the introduction, whole life and IUL treat these maximum charges very differently.

- A whole life policy establishes a premium large enough to accommodate the maximum mortality and expense charges; it assumes the worst, so to speak.
- The insurance company then adjusts downward via dividends based on favorable experience. In a sense, it "returns" the portion of the maximum charges that were not actually assigned to the cash value account.



In an IUL policy, the premium is not set based on an assumption of maximum charges. Instead, a set of current charges are assumed, which are below the maximum but not guaranteed to be the actual charges the policy will experience in the future.

- This allows more of the premium to go toward cash value growth, as policies are typically not charged the maximum rate.
- Under normal circumstances, IUL maximum rates are not applied. They are there to protect the solvency of the insurer and their policyholders if future experience does not prove as favorable as expected, and they need the ability to raise rates.

In essence, both IUL and whole life companies have built flexibility into their products if future markets are less favorable than assumed:

- In whole life, the dividend is not guaranteed, so the company can choose to keep more of the maximum mortality and expense charges.
- In IUL, the current expense and mortality charges are not guaranteed, so the company can choose to raise costs if needed in the future.



SUMMARY

Overall, IUL and whole life use different approaches to delivering value to their policyholders.

In addition to their many valuable features, IUL offers additional value through transparency, indexed crediting and direct accounting of costs in the policy. Whole life brings value through annual dividends.

You can choose cash value life insurance to help meet the dual needs of death benefit protection and cash value growth. Each product offers a different emphasis between the two:

- In general, whole life policies tend to generate higher death benefits at the expense of savings growth, and IUL policies tend to favor cash value growth while keeping death benefits closer to the IRS minimums.

As with any insurance or financial product, your unique needs will ultimately determine if life insurance is appropriate for you, and if so, which approach is best for your specific situation.



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