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Commentary

Whole Life Insurance Can Improve Planning Outcomes

The tax-deferred growth of its cash value and the guaranteed tax-free death benefit are among its advantages.

By **Ross Junge and Michael Finke**

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Few financial products generate as much emotion from both supporters and critics as permanent life insurance. The granddaddy of permanent insurance is whole life insurance, which still represents a third of the individual life insurance market according to LIMRA.

The percentage of Americans who own permanent life insurance has declined in recent decades, and many advisors outside of the insurance industry are unfamiliar with the basics of the product structure.

The inability for fee-only advisors to be compensated from the sale of a permanent insurance product leads some advisors to dismiss a product they view as a lesser alternative to traditional investments. In reality, a product like whole life can be integrated into a financial plan for clients who benefit from its unique tax and performance characteristics.

The primary purpose of a whole life policy is to provide a lump sum of money at death. To provide the death benefit, the whole life product incorporates two basic elements: a mortality expense and a tax-deferred savings component called cash value.

The performance of the policy will depend on the competitiveness of the cost of insurance and the tax-advantaged growth in the cash value.

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The design of a whole life policy reflects the mechanics of human mortality. While the cost of mortality protection rises with age, the premium on a whole life policy remains level.

How is this possible?

For a younger person, the whole life premium generally consists of a small percentage that pays the annual mortality protection cost and a larger portion that is set aside in a reserve and invested by the insurance company in a general account.

The cash values that build over time are a result of the performance of the general account, along with the insurance company's success with expense management and favorable mortality experience. The cash

value growth offsets the higher mortality costs later in life, thus creating the level premiums.

The value from the policy will eventually be returned to your heirs (net of expenses) in the form of a tax-free death benefit or living benefits can be accessed during the insured's life via the cash values inside the policy. Unlike other after-tax investments outside of retirement accounts, the growth on the cash values is not immediately taxed.

This is one of the most important tax benefits of a whole life policy, which results in long-term compounding advantages versus something like a taxable investment.

Unlike the investment income "tax drag" of a traditional investment account, the amount that your beneficiaries receive at death is tax-free, and a portion of the cash values can also be accessed as living benefits without being taxed.

How are the premium dollars invested in the general account portfolio of an insurance company?

The purpose of these investments is to ensure that the insurance company can pay policyholder claims, which means that their portfolios should consist primarily of diversified high-quality bonds.

This is why the performance of a whole life insurance product shouldn't be compared to the performance of risky assets like equity mutual funds or ETFs.

Any financial strategy should be judged based on its ability to efficiently meet the client's goals. The primary purposes of whole life insurance are to provide a long-term death benefit to protect a spouse or family or fund a legacy goal.

The guaranteed tax-free death benefit of a life insurance policy does that and can also create retirement distribution planning advantages by allowing more freedom to spend down assets in retirement and provide flexibility with cash values as a source of tax-advantaged emergency savings.

Growth in the cash value of whole life insurance has historically exceeded other lower-risk bond investments like tax-advantaged municipal bonds or taxable bonds after adjusting for ordinary income taxes.*

Whole life products also become more efficient the longer you hold them since insurance costs are generally more front-loaded and the compounding tax

advantage rises as cash value builds within the product over time.

For a healthy, high-income-tax-bracket individual or family, the cost of insurance is generally lower than the cost of taxes, which results in a wealth accumulation advantage for whole life relative to similar bond investments.

An often-ignored added benefit of a whole life policy is the low variation in the policy's cash value over time.

For example, in March 2020, intermediate-term corporate bond funds fell by nearly 20% during the liquidity crisis caused by the COVID pandemic.

However, cash values accessible to whole life policy owners did not decline. This artificially smoothed return of cash values within whole life policies provides stability to an overall financial plan in times of uncertainty.

Including whole life in an overall financial plan can help improve planning outcomes by providing more certainty with the guaranteed, tax-deferred growth of cash value, providing a tax-free death benefit, planning flexibility and financial security.

It is best to see whole life insurance as a tool in an advisor's toolbox of financial instruments that can be used to meet a client's goals most efficiently. For higher-income clients with legacy needs and significant non-qualified assets, whole life may just be the best tool available.

** Based on a comparison of a hypothetical mix of intermediate-term bonds net of fees and taxes and a $500,000 hypothetical whole life policy for a 35-year-old healthy man during a period of 1950-1979.*

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