(Legally) Cutting Out the Tax Man in Retirement

by Scott Mann, Published by **FOX BUSINESS** February 22, 2012

The life insurance industry has the best IRS-approved retirement savings plan today—and most investors know nothing about it. This retirement savings vehicle is not a company-sponsored, pre-tax qualified, 401(k)-type plan. It's also not a Roth. It's not an annuity or whole life. Despite sales of well over $1 Billion in 2011 for the top 39 carriers surveyed, it is the financial industry's No. 1 secret—Indexed Universal Life (IUL).

To explain why IUL is a powerful supplemental saving vehicle to an employer's 401(k) plan, and a replacement for those whose employers don't offer one or for some people who don't trust the market, we need to start with the fact that after a generation of use, qualified plans—comprised of equity-based investments—are generally acknowledged as failures.

Why is this the case? For one, the performance of qualified plans has been abysmal. Most investors have not made money in the stock market in a decade. Investors haven't made money since before Google existed, since before the events of 9/11! The second factor is low employee participation. The two market catastrophes we have experienced since 2000 notwithstanding, one major reason people fail to save is fear of losing their money. With the recent stock market plunges, various reports say many consumers, including those in their 20s and 30s, are too afraid to save in the market, despite the market's historical role as the best long-term place to save.

The 401(k) retirement account has long been the "go-to" first bucket to fill to provide for retirement needs, yet this is a mistake. Stephen Gandel devoted his article in TIME magazine's Oct. 9, 2009 issue to "Why It's Time to Retire the 401(k)":

The ugly truth is that the 401(k) is a lousy idea, a financial flop, a rotten repository for our retirement reserves . . . . The solution: a new type of insurance. Retirement savings, it turns out, are exactly the type of asset we need insurance for. We need insurance to protect against risks we can't predict (when the market collapses) and can't afford to recover from on our own . . . . Recent opinion polls show that people would be willing to give up the flexibility of a 401(k) for a guaranteed return. 1

Gandel's idea is not really new, having enjoyed a 14-year track record. You insure nearly every other aspect of your life: your health, your home, your vehicles. Why not protect your safe, comfortable retirement against the risks we can't predict and can't afford to recover from on our own, and why not cut out the tax man in the process? These are all legal, and totally above board, established life insurance principles. It may sound too good to be true, but it's just what life insurance is and does. Yet the general public—and even many financial advisors—have absolutely no idea that a tax-free, market-risk-free, gains-locked-in, congressionally-approved solution has been sitting right under their noses for 14 years. Indexed Life's primary benefit is the fact that, like an indexed annuity (and unlike a mutual fund Roth), you keep all the gains and suffer none of the market losses. But there are many more benefits included that no other investment can lawfully offer, with the possible exception of a Roth.

Let's lay out the basic principles of Indexed Universal Life (IUL), and then let me take you through a rough equation to crystalize just how powerful a retirement savings tool this vehicle is.

Indexed Universal Life's basic principles:

1. Can be funded with after-tax monies or pre-tax monies, as in a defined-benefit pension plan.

2. Assets are protected against market loss and backed by the full faith and credit of the issuing company. While the funds are not FDIC-insured, "legal reserve" requirements apply with the insurers.

3. Assets are "linked" to the market via the selected index: Dow, S and P 500, Global, or a mix of several indices.

4. Any gains, being real, interest-bearing gains (subject to a cap), are locked in and never given back: the policy holder accrues a gain, or a zero (in the case of a down market), but never a market-induced loss.

5. Historical returns, based on actual illustrations from the top carriers going back to the late 1980s, are usually somewhere between 7-9%, mean actual interest rates of return.

6. Income can be pulled out prior to age 59.5 and is "tax-free." A withdrawal is considered a policy loan against the death benefit, which acts as collateral.

7. The death benefit is paid out to the beneficiary tax-free.

Let's use an actual client case study and illustration to do the math. Now, this is just an illustration, and if there is one thing to consider about an illustration, it's that its accuracy can't be guaranteed, as it's a hypothetical estimate.

For our example, let's use a hypothetical client. Jim, age 40, has been happily married to June, age 35, for 16 years. They have two young children, ages 6 and 8 years. How much would Jim have to put away into conventional stock-based, non-principal-protected, non-tax-free investments to get the same income benefit in retirement?

Here are some rough numbers. They can afford to fund the Indexed Universal Life account with $1,666.66 (totaling $20k per year) by the automatic bank draft from his institution to the insurance company. The plan is very flexible, but they plan on funding this for 24 years, then to begin taking retirement income at age 65 for the remainder of their lives. It will become like their own self-funded, self-controlled, tax-free hybrid pension. He would have invested a total of $480,000 over 24 years, then turned around and started pulling tax-free income in year 25. The illustration shows tax-free income of $162,399, at their tax rate of 30%, an equivalent income of $211,118 per year.

Now, how much would Jim have to invest MONTHLY, in another investment (stocks, bonds, real estate) over the same time frame, assuming it made an average of 8% per year, to be able to pull 5% out for the rest of his life?

Starting with the $221,118 per year tax equivalent income, divided by 5% recommended income withdrawal rate from stocks/bonds, the total comes to $4,222,374. This is what we would have to save over this 24-year period, the future value of his monthly investment + 8% average, every year, without fail, in the actual stock market. Now let's use the financial calculator to find the monthly payment in today's dollars, making 8% (assuming you could make 8% in the market) over the 24-year period before you would begin taking income. You would have to invest $4,872 per month, every month, (that's $58,465/year), or $1,403,161 in principal alone, earning 8% for 24 years to equal this $4,222,374, in stark contrast to the $480,000 he put away in principal for the IUL.

Again, this is just an example, but it shows that an IUL would have provided from age 65 to age 85 $3,247,980 in total tax-free income, then a tax-free death benefit of $922,638—for a total tax-free family benefit of $4,170,618. This could represent a large portion of their income needs. While past performance is never any guarantee of the future, we really cannot illustrate these products historically at less than 7-9% interest rate returns, since you make a gain or you get a zero. On top of this, these returns are all passive; you didn't have to manage anything. As a footnote, since there is no age 59.5 restriction, many parents use IUL cash values for college funding as well.

It looks like odds are good that Indexed Universal Life may offer you roughly two to three times the amount of benefit over conventional investments, depending on the actual index returns and your tax bracket. This is a result of protection of principal against market losses, the indexing, and legally cutting out the tax man. You have harnessed what Einstein called one of the most powerful forces in the universe: compounding interest.