

Advantages of a 401(k) Plan

Let me back up a minute and explain exactly what a 401(k) plan is. It's an income and tax deferral plan (often called a **cash deferral** or **cash and carry plan**) established by an employer solely for employees. If your employer has established such a plan, then you can defer a certain percentage of your income each year, up to a specified maximum (\$8,728 in 1992), by putting it into your 401(k) plan. This maximum goes up each year. Thus, a 401(k) plan allows you to defer having to pay tax on some of your income each year because you don't pay tax on any of the money in the plan until you take it out.

The big plus of 401(k) plans is that employers are permitted to match employee contributions. These contributions are not only "free money" for the employee, but they, too, are tax-deferred. Each employer has a right to match employee contributions to 401(k) plans at any rate between zero and \$1.00 for each dollar the employee contributes. All employees must be matched at the same rate. (Employers also have the right to provide no matching contributions at all.)

For example, if your employer matches your contributions at 25 cents on each dollar, then if you were to defer \$8,728 in income this year by putting it into your 401(k) plan, your employer would add another \$2,182 to your plan. None of this money will be subject to tax until you choose to take it out. Obviously, this setup makes your 401(k) plan extremely worthwhile, since you earn a 25 percent return on your investment the moment you make it. Some employers not only match a percentage of your contributions, but also give you a choice of how you want the money in your 401(k) plan invested—in a stock account, a bond account or some other investment vehicle.

Earnings on the assets in a 401(k) fund can vary widely, depending on inflation, the state of the economy and the particular investment vehicle selected. In general, though, 401(k) plans manage to at least keep up with inflation, and usually do somewhat better.

Putting money into a 401(k) plan is often an excellent idea, particularly if your employer also contributes matching funds.* But once you have gotten the maximum amount of matching funds from your employer for the year—or if your employer provides no matching funds at all—then a 401(k) plan becomes considerably less valuable. Indeed, under these circumstances you are likely to achieve far better financial results with a good whole life insurance policy from a strong carrier than you are with any 401(k) contributions.

* Each person's situation is different, however, so it is a good idea to consult with your tax adviser before deciding to contribute—or not contribute—to a 401(k) plan or any other profit-sharing, pension or retirement plan.

Whole Life versus a 401(k) Plan

Let's compare these two options in detail. We'll begin by looking at the tax implications of 401(k) plans. Any money you withdraw from a 401(k) plan is fully subject to income tax in the year in which you take it out, based on whatever tax bracket you fall into during that year. In other words, you've successfully deferred your tax, but you haven't eliminated it. (Compare this with a well-managed whole life policy, which yields 100 percent tax-free funds.) Furthermore, the better off you are financially when you withdraw money from your 401(k) plan, the higher a tax bracket you'll fall into and the heftier a percentage you'll have to pay Uncle Sam (and, perhaps, state and/or local governments).

Furthermore, neither you nor I nor anyone else has any idea what the actual tax rates will be on the money you withdraw years from now. When Ronald Reagan first took office, the top tax bracket for federal income tax was 70%. As of March 1993, it's 31 percent. My own best guess is that the 31 percent maximum is not going to last very long. Indeed, I think it's quite possible that, no matter *what* tax bracket you're in now, you could end up paying as much or more in taxes on any deferred income when you actually withdraw it.

But even if income tax rates go down in the future—something I find all but inconceivable—the fact is that *all income taken out of a 401(k) plan is subject to income tax*. And why pay tax if you don't have to? Because you *don't* have to. As I explained earlier in this chapter in the section headed "Surrendering and Borrowing," you don't have to pay a penny of tax on money you receive from a life insurance policy if you use that policy properly. Furthermore, if you put money into life insurance, then when you die, your beneficiary gets a death benefit—whereas if you die with just the money in your 401(k) plan, your beneficiary gets nothing more than the money in that plan.

There's another, less obvious difference. If you buy a life insurance policy with a disability waiver of premium rider, then if you're disabled for an extended period of time, you can stop paying premiums for as long as your disability continues. Meanwhile, your cash value (and, if you wish, your death benefit) continues to grow. In comparison, with a 401(k) plan neither you nor your employer will make payments to your plan while you're disabled.

Let's take a close look at dollars and cents. Figure 11.3 shows a breakdown of how a good whole life policy and a typical 401(k) plan stack up against one another. We'll use our longtime acquaintance, Dr. Suture, as an example, and we'll use his Extra Value Whole Life 98 policy for our comparison. (See Figure 11.1, p. 162.)

Since Dr. Suture is a fairly typical American, let's assume that he'll retire at age 65 and live to be 80. Right now, though, Dr. Suture is only 35, and he has a choice:

Figure 11.3 Qualified Plan versus Supplemental Income Plan (Nonqualified)—First Comparison for Dr. Suture

<p>Qualified Plan* Annual Contribution</p> <table border="1" style="margin: auto;"> <tr><td>Gross</td><td>6,212</td></tr> <tr><td>Tax</td><td>-0-</td></tr> <tr><td>Net</td><td>6,212</td></tr> </table> <p>for 30 Years</p>	Gross	6,212	Tax	-0-	Net	6,212	<p>Assumptions: 7% Investment Return 35% Tax Bracket</p>	<p>Supplemental Income Plan** Non-Qualified Annual Contribution</p> <table border="1" style="margin: auto;"> <tr><td>Gross</td><td>6,212</td></tr> <tr><td>Tax</td><td>2,174</td></tr> <tr><td>Net</td><td>4,038</td></tr> </table> <p>for 30 Years</p>	Gross	6,212	Tax	2,174	Net	4,038						
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* The qualified plan is subject to annual administration costs and a potential 15 percent excise tax.

**The SIP is based on a current dividend crediting rate and includes a waiver of premium disability benefit.

he can put some of his annual salary into a 401(k) plan, or he can purchase a good whole life policy.

To draw a fair comparison between these two options, we have to know what kind of a return Dr. Suture would earn on the funds in his 401(k) plan and how much income tax he'll have to pay on any earnings that he *doesn't* put into this plan. Let's assume a reasonable 7 percent return on any funds in this plan and a combined federal and state income tax of 35 percent.

Look at the chart in Figure 11.3, which compares these two plans head to head. We'll start with the 401(k) plan, on the left. I've used the term **qualified plan** here because that's what the U.S. government calls 401(k) plans, as well as Keoghs and most pension and profit-sharing plans. I've also used this more general term because the comparison I've set up here applies just as much to other qualified plans—and to IRAs as well—as it does to 401(k) plans.* On the right-hand side of this comparison, we have a supplemental income plan, the now-familiar Extra Value Whole Life 98 policy. This does not fall under the government's definition of a qualified plan, so let's call it a **nonqualified plan**.

A close look at the numbers tells us that Dr. Suture has \$6,212 of income to put aside each year until he retires at age 65, 30 years from now. If he were to put that money into a 401(k) plan, his total contribution to the plan after 30 years would be \$186,360. If the money in this plan were to earn 7 percent annual interest, then his actual cash accumulation at age 65 would be \$627,866.

But now let's look at the right-hand column. If the doctor were to go with the Extra Value Whole Life policy instead, things would work out a little differently. First of all, because he wouldn't be deferring that \$6,212 of income annually, he'd owe income tax on it every year. At 35 percent, this means that he'd have only \$4,038 to spend each year on life insurance. This is precisely the cost of the annual premium on the Extra Value Whole Life policy in Figure 11.1. If he buys this policy, and if it performs as projected, at the end of 30 years he'll still have paid out \$186,360 (\$121,140 to the life insurance company, \$65,220 to the federal and state governments in taxes). His illustrated cash value after 30 years would be \$462,854.

So far the 401(k) plan appears to be ahead, \$627,866 to \$462,854. But remember, all of the money in the qualified plan is fully taxable when it's withdrawn, whereas with some thoughtful planning, Dr. Suture can use almost every penny of his life insurance cash value without paying a penny of tax. And if we reduce \$627,866 by 35 percent, we end up with only \$408,113.

But let's say that Dr. Suture decides to put his money into the 401(k) plan. One option he has when he retires at 65 is to take the \$627,866 in a lump sum—

all of which is subject to income tax as it is withdrawn—and use it as he pleases. However, few people are very willing to select this option because they're afraid they won't be able to manage the money effectively—or, worse, that they'll use up all of it and still be alive, well and poor. (Furthermore, in the case of certain pension plans—though *not* 401(k) plans—employers simply won't allow employees to withdraw the funds from their plans in a lump sum; they insist that their employees choose from one of the options that follow.)

The Single-Premium Immediate Annuity

So what Dr. Suture could do, as many other people do at retirement, is use his accumulated funds to purchase an annuity. This would be a **single-premium immediate annuity yielding a life income**. In other words, Dr. Suture would make a single payment of \$627,866 and, in return, receive a large chunk of cash each year for the rest of his life, beginning immediately, regardless of whether he died at 66 or 106.

Look at the bottom left-hand corner of Figure 11.3. If the doctor bought an average annuity with his money, he'd receive \$63,067 annually until he died. This money would be fully taxable, and that tax would come to \$22,073 a year. Thus, Dr. Suture would end up with \$40,994 to spend each year for the remainder of his life. If he lived to his life expectancy of 80, then his total income from this annuity arrangement, after taxes, would be \$614,910.

That's pretty good. But let's compare it to the Extra Value Whole Life plan, using the scenario in Figure 11.1. (Also look at the bottom right-hand corner of Figure 11.3.) You'll recall that by following this strategy, the doctor can make use of \$44,579 from his policy each year for 15 years. *This money is completely tax-free*. So, under this scenario, by age 80 Dr. Suture would receive \$668,685. That's over \$50,000 more than the 401(k) plan would provide.

But there's another element we've overlooked entirely. By adopting the second strategy just described, Dr. Suture has *also* gotten life insurance protection for 45 years. If he died at any time before his 80th year, his beneficiary (in this case, Mrs. Suture) would receive a hefty death benefit. Depending on when he died, this would be anywhere from \$250,000 to almost \$1,000,000 (assuming the policy performed according to the illustration).

The Joint and Survivor Option

Before we move on, let's consider one other comparison. Most people who purchase an annuity opt for a *joint and survivor* option, which covers two people

* IRAs are not considered qualified plans under the federal government's definition.

(usually a married couple). Under such an arrangement, annuity payments continue until both covered people have died.

Look at the bottom center of Figure 11.3. If Dr. Suture and his wife were to purchase a typical joint and survivor annuity, they'd receive payments of \$51,730 a year. Of this, \$33,624 would remain after taxes. If both of the Sutures were to live to their life expectancy of 80, then the total amount of cash they would have cleared from their annuity would be \$504,360.

The Extra Value Whole Life policy far outperforms either annuity option in this comparison. But to get some idea of just how *much* it outperforms them, look at Figure 11.4 (p. 178). Here we'll compare horses to horses instead of horses to ponies.

The comparisons in Figure 11.4 are based on the same information and assumptions as those in Figure 11.3, with one exception: In the left and center columns of Figure 11.4, I've also added in the cost of buying term insurance—enough to equal the amount of coverage provided to Dr. Suture in the Extra Value Whole Life policy, less the amount of cash in his 401(k) plan.

The cost of buying this insurance is more than just the term premiums, however, because for every dollar Dr. Suture earns that he doesn't put into his 401(k) plan, he has only 65 cents to spend after taxes. This means that, in order for him to pay the \$278 first-year premium for a typical term policy, he has to earn \$428—and that's \$428 less that he can put into his 401(k) plan. Each year thereafter, of course, his term premiums get larger, which means that each year his 401(k) contribution is smaller than the one he made the year before.

The resulting differences between the qualified plan and the nonqualified Extra Value Whole Life policy are dramatic. Look at the bottom half of Figure 11.4. Once the cost of paying for term insurance is taken into account, Dr. Suture will have only \$294,550 in his 401(k) plan when he retires, compared with \$462,854 in cash value in his whole life policy. If he purchased an annuity with the money in his qualified plan, the differences would become more dramatic still. An average life income annuity would yield the doctor only \$19,227 a year in after-tax dollars, compared with \$44,579 in tax-free cash from the life insurance policy. And if Dr. Suture opted for a joint and survivor arrangement for himself and his wife, the Sutures' annual after-tax income would be a mere \$15,771.

Figure 11.5 (p. 178) provides a year-by-year comparison of these two different arrangements—the 401(k) plan plus term insurance versus the Extra Value Whole Life policy—for the first 30 years, through age 65. In the right-hand quarter of the figure is information on the life insurance: the annual premium (Annual Plan Outlay) of \$4,038, the illustrated cash value (Account Balance) for each year, and the death benefit (Survivor Benefit) for each year. The remainder of the figure shows how Dr. Suture's funds would need to be

delegated if he were to purchase enough term coverage to yield an equivalent death benefit and put the remainder of his \$6,212 annual outlay into a 401(k) plan. Column 5 (Contribution to Side Fund) is the amount Dr. Suture could put into his qualified plan each year after paying the term premium. Column 4 (Annual Term Premium) represents the amount of money the doctor must *earn*, before taxes, in order to buy sufficient term coverage. (Remember, for every dollar he earns that does not go into his qualified plan, only 65 cents goes toward actually paying his term premiums.)

Column 9 (Total Death Benefit) represents the total amount of money that Dr. Suture's beneficiary, his wife, will receive if he dies prematurely. This amount equals the total amount of illustrated death benefit (column 12) provided by the Extra Value Whole Life policy. Because Mrs. Suture will inherit all of the money in her husband's 401(k) plan if he dies, Dr. Suture does not need to buy as much term coverage as the Extra Value Whole Life plan provides to attain the same level of death benefit. He needs to purchase only enough term death benefit to equal the illustrated death benefit in column 12 *minus* the amount of money in his qualified plan. The amount of term death benefit he will need to buy each year is listed in column 8. Column 6 (Side Fund Earnings) indicates the amount of money the 401(k) pays in interest each year. Column 7 (Side Fund Balance) is the total amount of money in Dr. Suture's qualified plan. *Note that beginning in year 20 of this scenario, the cost of buying term coverage exceeds \$6,212 a year, and the doctor must begin taking money out of his qualified plan in order to make up the difference.*




This comparison probably seems graphic enough. But let's compare the two different strategies in another way, on a feature-by-feature basis. The comparison in Figure 11.6 once again demonstrates the clear superiority of the life insurance supplemental income plan over the qualified plan.

Given the choice, which option would you select?

I strongly recommend the following basic financial strategy for almost every salaried employee: If your employer provides a reasonable match for contributions to a 401(k) plan, then each year put in as much money as your employer will match, up to your legal limit. Those matching funds really make your 401(k) plan worthwhile. Once you've reached the limit of matching funds, however, steer clear of your 401(k) plan. Take the rest of the money that you want to put toward your future and use it to buy an appropriate life insurance policy from a first-rate carrier.

The same advice applies to other qualified plans—Keoghs, most pension and profit-sharing plans, and so on. A good whole life policy, properly managed, is almost always your better bet unless some other person or organization is putting money into the plan for you.

Figure 11.4 Qualified Plan versus Supplemental Income Plan (Nonqualified)—Second Comparison for Dr. Suture

Qualified Plan* Annual Contribution Minus Cost of Term	Assumptions: 7% Investment Return 35% Tax Bracket	Supplemental Income Plan* Non-Qualified Annual Contribution																		
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Figure 11.5 Year-by-Year Comparison of 401(k) Plan Plus Term Insurance versus Extra Value Whole Life Policy

END OF YEAR	AGE	PLAN CONTRIBUT'N	ANNUAL TERM PREMIUM	CONTRIB'N TO SIDE FUND	SIDE FUND EARNINGS	SIDE FUND BALANCE	TERM DEATH BENEFIT	TOTAL DEATH BENEFIT	ANNUAL PLAN OUTLAY	ACCOUNT BALANCE	SURVIVOR BENEFIT
1	36	6,212	428	5,784	405	6,189	250,703	256,892	4,038	1,433	256,892
2	37	6,212	511	5,702	832	12,723	251,682	264,405	4,038	4,733	264,405
3	38	6,212	571	5,641	1,286	19,650	253,077	272,727	4,038	8,365	272,727
4	39	6,212	638	5,575	1,766	26,990	254,885	281,875	4,038	12,364	281,875
5	40	6,212	706	5,506	2,275	34,771	257,112	291,883	4,038	16,764	291,883
6	41	6,212	776	5,436	2,815	43,022	259,748	302,770	4,038	21,601	302,770
7	42	6,212	849	5,363	3,387	51,772	262,811	314,583	4,038	26,917	314,583
8	43	6,212	930	5,282	3,994	61,048	266,732	327,780	4,038	32,849	327,780
9	44	6,212	1,017	5,196	4,637	70,880	271,513	342,393	4,038	39,453	342,393
10	45	6,212	1,113	5,099	5,319	81,298	277,103	358,401	4,038	46,788	358,401
11	46	6,212	1,658	4,554	6,010	91,862	283,978	375,840	4,038	54,919	375,840
12	47	6,212	1,891	4,322	6,733	102,916	291,793	394,709	4,038	63,912	394,709
13	48	6,212	2,150	4,062	7,488	114,467	300,161	414,628	4,038	73,738	414,628
14	49	6,212	2,479	3,733	8,274	126,474	309,171	435,645	4,038	84,470	435,645
15	50	6,212	2,878	3,334	9,087	138,895	318,910	457,805	4,038	96,187	457,805
16	51	6,212	3,346	2,866	9,923	151,684	329,459	481,143	4,038	108,964	481,143
17	52	6,212	3,901	2,311	10,780	164,775	340,973	505,748	4,038	122,900	505,748
18	53	6,212	4,560	1,653	11,650	178,077	353,625	531,702	4,038	138,084	531,702
19	54	6,212	5,354	858	12,525	191,461	367,640	559,101	4,038	154,625	559,101
20	55	6,212	6,298	(85)	13,396	204,772	383,269	588,041	4,038	172,627	588,041
21	56	6,212	7,452	(1,240)	14,247	217,779	400,836	618,615	4,038	192,206	618,615
22	57	6,212	8,741	(2,529)	15,068	230,318	420,603	650,921	4,038	213,500	650,921
23	58	6,212	10,285	(4,073)	15,837	242,082	442,934	685,016	4,038	236,632	685,016
24	59	6,212	12,181	(5,968)	16,528	252,642	468,305	720,947	4,038	261,748	720,947
25	60	6,212	12,754	(6,542)	17,227	263,327	495,493	758,820	4,038	288,979	758,820
26	61	6,212	14,560	(8,347)	17,849	272,829	525,907	798,736	4,038	318,481	798,736
27	62	6,212	16,539	(10,327)	18,375	280,877	559,935	840,812	4,038	350,426	840,812
28	63	6,212	18,775	(12,563)	18,782	287,096	598,128	885,224	4,038	384,986	885,224
29	64	6,212	20,813	(14,601)	19,075	291,570	640,607	932,177	4,038	422,355	932,177
30	65	6,212	22,503	(16,290)	19,270	294,550	687,580	982,130	4,038	462,854	982,130

IRAs

As for IRAs, I'm probably asked about them at least as often as I am about 401(k) plans. But while I'm enthusiastic about 401(k) plans under certain circumstances, it's rare that I meet someone for whom an IRA makes much financial sense.

An IRA is a reasonably good place to put your money if you already have all the whole life insurance you need *and* if you've already gotten every matching dollar from your employer that you can in a qualified plan. Otherwise, though, there are far better things to do with your money. Many of the people I work with talk about wanting to make an IRA a part of their financial plan. But when they compare the benefits and drawbacks of an IRA against those of whole life insurance, few of them actually start an IRA.

IRAs have not exactly been a financial success story. In 1974, when IRAs first began, the U.S. government predicted that 40 million people would start

them. Only three million actually did—and within two years, half of those three million people took money out of their IRAs and paid a 10 percent premature distribution penalty. Why? Because they needed the money badly enough that they were willing to forfeit that 10 percent.

IRAs have some legitimate (if limited) uses, and they pay a reasonable rate of interest. But they have some significant drawbacks. Specifically, if you withdraw any money from your IRA before you reach the age of 59½, you must pay the following taxes and penalties:

- The 10 percent federal premature distribution penalty on the withdrawal
- In some states, a state premature distribution penalty as well
- Federal income tax on the withdrawn funds
- In some states, state income tax (and, in some locales, local income tax as well) on the funds

Figure 11.6 Feature-by-Feature Comparison of Qualified versus Nonqualified SIP Plans

	Qualified Plan	Non-Qualified S.I.P.
Contribution Limit	Yes	Unlimited
Tax Deferred	Yes	Yes
Flexible Funding	Yes	Yes
Flexible Investments	Yes	Yes
Withdrawals	59 1/2 Or Penalty	Anytime
Assignable	No	Yes
Loans	The Lesser Of 50,000 Or 50% Of Vested Interest	Yes
Self Completing At Death	No	Yes
Premium Waived If Disabled	No	Yes
Distributions At Retirement	Taxable	Tax-Free
Annual Cost of Administration	Yes	No

Why put money into an IRA when you can get so much more from a good whole life policy from a strong life insurance carrier? The following options are available with a whole life policy:

- You can take money out at any time by surrendering some or all of your paid-up additions, without a penalty of any kind.
- You can surrender the base policy at any time and collect your full cash value, again with no penalty.
- You can borrow against your policy at any time, usually at very favorable rates, with no questions asked.
- If you handle your policy properly, you can make use of every dollar of cash value in it without having to pay a penny of income (or any other) tax.
- If you die, your beneficiary gets a substantial death benefit tax-free.

Furthermore, a good high-cash-value policy from a strong life insurance carrier will often give you a higher rate of return over the long run than an IRA; it will also give you ongoing life insurance coverage. Which would you rather have for the same price: a smaller sum of money that's subject to tax or a larger one that you pay no tax on *plus* life insurance coverage?

If you're thinking about putting \$2,000 a year into an IRA, why not put it into whole life insurance instead? For the vast majority of people, it's a far more sensible, beneficial and cost-effective choice: You get a better return on your money over the long haul, access to cash without any penalties, big tax advantages *and* the protection of life insurance.

CREATIVE CONVERTING

If you own a term policy, the chances are very good that you will either convert it to some other type of life insurance or let it lapse entirely. *Less than 1 percent of all term policies actually pay a death benefit.* That's right. Literally 99 percent of all term plans are either converted to some other type of insurance or simply abandoned.

Therefore, if you do buy term insurance, it pays to think ahead. Assume that you will convert some or all of your term coverage to whole life, universal life or a blend—if not soon, perhaps some years down the line, when the term premiums become far more expensive, or when your needs and/or finances change. This means that you should *always* buy term coverage that is convertible to other forms of life insurance. Ideally, your term policy should be from a carrier that will give you a **conversion allowance**—a discount toward your first year's premium on your new insurance—if you convert your term plan within the first few years.

But there's yet another, more creative way to save money when you convert your term insurance. You can actually use your conversion privilege to *reduce the cost of buying additional life insurance.*

Let me show you how this works: Suppose you already own \$150,000 of whole life coverage and \$150,000 of term insurance. You bought the coverage four years ago, when you and your spouse had no children, so at that time \$300,000 of life insurance was sufficient. Now, however, everything's changed because earlier this year you adopted twins. Your family suddenly doubled in size—and so did your need for life insurance. Your agent has done a policy review and has suggested that you buy another \$300,000 in coverage. You've decided that you'll buy an additional \$150,000 of whole life insurance and another \$150,000 of term.

Now, you could simply buy two new policies and let it go at that. But your agent suggests a better strategy: *convert your existing term insurance to whole life and buy \$300,000 of new term coverage.* The resulting mix of coverage is the same: \$300,000 of whole life and \$300,000 of term. But you've gotten two significant benefits by converting your term insurance creatively.

First, term premiums start out quite low and then rise steadily over the years. Because you have gotten rid of your old term insurance and bought new coverage, you are no longer paying the higher premiums of a four-year-old policy; instead, you're paying first-year premiums again. Furthermore, since the premiums on your old policy would have continued to go up steadily from the fourth-year level, *you save money on every one of your future term premiums.* Over the life of your policy, this could amount to a difference of thousands of dollars. (This presumes that you would qualify for the same risk rating on your new term coverage that applied to your old term policy.)

Second, if your original term policy had a conversion allowance that could be applied in the fourth year of the policy (as many term policies do), you would receive a reduction in your first-year premium for your new whole life policy—thus saving you still more money.

You can employ this strategy over and over if you wish, saving more money each time. For example, let's suppose it's five years later. You have another child, you're living a more comfortable life-style and you decide you want to build cash for your retirement at a faster pace. You're thinking about adding another \$200,000 of whole life coverage, as well as another \$100,000 of term insurance. Once again, instead of simply buying two more policies, you convert \$200,000 of your term coverage to whole life and buy \$100,000 in new term insurance. Again, you get the benefits of paying low first-year premiums on the new term coverage, the security of conversion to whole life without having to provide any evidence of insurability and,

perhaps, a discount on your first-year whole life premium through another conversion allowance.

THE MORTGAGE REDUCTION ALTERNATIVE

One excellent option that you may wish to build into your personal financial plan is a mortgage reduction strategy. This is *not* what is sometimes called **mortgage insurance**,* in which you own a term life insurance policy with a decreasing death benefit roughly equal to the amount you owe on your mortgage. Instead, it is a creative and flexible way to use whole life insurance to pay off your mortgage in less than 20 years—and at the same time to obtain life insurance coverage at very little cost.

When most people buy a home, they opt for either a 15-year or a 30-year mortgage. Some home buyers, however, want more flexibility; they'll take out a 30-year mortgage, but they'll arrange it so that if they wish to (and can afford to), they can pay it off in 15 years and save a huge amount in interest. They'll be given two different payment schedules—one for 30 years and an accelerated payment schedule for 15 years. They'll then do their best to pay off their mortgage in 15 years and be done with it.

This flexibility is nice to have, of course. But in practice, few people have the financial discipline to actually make the higher mortgage payments when they don't absolutely have to, even though doing so would cut the length of their mortgage in half and save them tens of thousands of dollars. Because their only *obligation* is to make the smaller monthly payments on the 30-year mortgage, most people end up making mortgage payments for the full 30 years.

When it comes to buying a home, then, people normally consider three options: (1) a 15-year mortgage, (2) a 30-year mortgage and (3) a 30-year flexible mortgage that can be paid off in 15 years by accelerating the payments. Let me suggest a fourth option, however: a **mortgage reduction plan** that makes use of whole life insurance. Here's how it works:

Arrange with a lender for a traditional 30-year mortgage. But before you sign your name to the mortgage, have the lender run a 15-year amortization schedule for you so you can see what it would cost each month to pay off the mortgage in 15 years instead of 30. Let's say that you want to buy a home that currently sells for \$150,000. (This is roughly what an average home sold for in the United States in July 1992—

though in many areas homes are far more expensive.) At prevailing rates as of July 1992, the monthly payments for a 30-year mortgage (at 8.25 percent) on this home will come to \$1,127. Monthly payments on a 15-year mortgage (at 7.75 percent) will come to \$1,412. *Plan to spend \$1,412 a month for both your mortgage and a good whole life insurance policy.*

Next, do some simple arithmetic. Figure out the difference between what your mortgage payments would have been each month for a 15-year mortgage and what they will be each month for your 30-year mortgage. In this case, that difference would be \$285 a month. *Plan to put this \$285 each month into a strong whole life plan from an excellent life insurance company.* This should be a policy with high cash values—that is, one that builds cash quite quickly but that has a comparatively low death benefit. For example, if you're paying \$285 a month (\$3,420 a year) into your policy, it might have a death benefit of \$100,000 to \$150,000.

Each month, then, you will make a payment of \$1,127 on your 30-year mortgage, as well as a \$285 payment on your whole life policy. Keep up this strategy for the first 15 years. But after the 15th year, monitor your policy carefully every few months. Based on current assumptions (as of July 1992) from most strong carriers, *it will take about 16 to 19 years (depending on your age) for your policy to build up enough cash value to pay off your mortgage entirely.* However, you would not pay it off by surrendering your policy or any of your paid-up additions, but by borrowing against your cash value.

For a concrete example, we can use our longtime friend, Dr. Suture, who has just decided to buy a 30-year mortgage on a \$150,000 house. According to a standard amortization schedule (at 8.25 percent) for a 30-year mortgage, after 17 years \$107,622 of his mortgage would remain.

Now let's look back at Figure 11.1 (p. 162), for the doctor's Extra Value Whole Life policy. If this policy performs as projected, its cash value will be \$122,900 at the end of its 17th year. This means enough cash value will be in it after 17 years for him to borrow \$107,622, own his home free and clear and still have \$15,278 in unencumbered cash value left. (If his policy were to perform a little better or a little worse than in the illustration, he'd be able to pay off his mortgage somewhat earlier or somewhat later.)

Now, remember, the doctor has calculated things from the beginning so that he's spent exactly the same each month as he would have if he'd taken out a 15-year mortgage. So he's spent the same amount of money each month, but he's spent it for 17 years instead of 15. But what has Dr. Suture gotten for his two extra years of payments? First, he's paid off his home in full. Second, he's gotten 17 full years of life insurance coverage. If he had died at any point during those 17 years, his beneficiary (in this case, his wife) would have received a death benefit of at least \$250,000. If she

* See *decreasing term insurance* on p. 84 for more details on term life insurance policies marketed as mortgage insurance. These policies are neither appropriate nor worthwhile for the great majority of Americans.

wished, she could then have used a portion of that death benefit to pay off the rest of the mortgage—and still have a significant amount of cash left over.

Third, because Dr. Suture wisely purchased a disability waiver of premium rider on his policy, if he had become totally disabled and unable to work, his life insurance coverage would have continued automatically. In addition, his cash value and death benefit would have continued to grow steadily, *without his having to pay a penny in premiums*, for as long as that total disability continued. This means that the doctor's mortgage reduction plan would also continue, unchanged, at no cost to him. *In the event of a total disability, both his life insurance and his mortgage reduction strategy would be self-completing.*

So far, this probably sounds pretty good. But Dr. Suture could actually have done much better. I used his Extra Value Whole Life policy because it was a handy example. But if you were to set up a mortgage reduction plan of your own, you probably wouldn't want or need an initial \$250,000 death benefit. A better choice would be a policy with higher cash values and lower death benefits. If Dr. Suture had taken that \$285 a month difference I talked about earlier and put it into such a policy from an excellent carrier, then (if his policy performed according to its projections) he'd have been able to pay off his mortgage in even less time—in only 16 years, perhaps.

Now let's add one more step to this process. After 17 years, Dr. Suture has no more mortgage payments to make, thus reducing his monthly expenses enormously. What he should do now is take the amount he used to spend in house payments each month and use it to repay the loan against his policy. *After about 12 years (based on prevailing interest rates as of July 1992), he will have completely repaid the entire loan, including any interest.* (The number of years it takes to repay a policy mortgage loan can vary, depending on the size of the loan, the size of your repayments and the interest rate you are charged. However, if you were to continue spending the same amount per month that you spent on mortgage payments, you'd repay your loan in full, including any interest, in 7 to 15 years.) Furthermore, once Dr. Suture's loans have been repaid, his illustrated cash value will have grown to \$422,355. His projected death benefit will have grown even more—to \$932,177.

So by following all the steps of this mortgage reduction plan, what will Dr. Suture have accomplished after about 29 years? First, he'll have a home that's completely paid for after 17 years—a home that cost \$150,000 when he first moved in and that could be worth far more now, 29 years later. Second, he'll have enjoyed 29 years of life insurance protection, with a death benefit that has grown to over \$932,000. If he had died at any time during those 29 years, his wife would have received a hefty amount of cash. Third, since all of his loans will have been repaid, he'll have \$422,355

in cash value that he can use to supplement his retirement income—or for any other purpose he wishes.

And *that* is what makes the mortgage reduction alternative so very attractive—and so very sensible.

SENDING YOUR KIDS TO COLLEGE

If you have (or are planning to have) children, your overall financial plan will probably include the cost of sending them to college. It may also include the cost of sending them to private or parochial school when they are younger. However, even if you do not plan to pay the full cost of schooling for your kids, when you're putting together your financial plan, it still makes sense to consider what those costs are likely to be.

In 1992, the average cost of putting one child through four years of college was well over \$60,000. By the year 2000, if college costs keep rising at the rate of 8 to 9 percent a year (which they have been doing for quite a while), getting a four-year degree will cost over \$115,000. And if you were to become a new parent in 1993, by the time your child turns 18, the cost of earning a bachelor's degree will have risen to a full \$250,000.

And that's only for an undergraduate degree. If your child decides to get an advanced degree, or if you plan to send him or her to a private elementary and/or secondary school as well as to college, the costs zoom far, far higher. And *that's* only for one child. If you have two kids, you'll need to double your estimated educational expenses; if you have three, you'll need to triple them.

A variety of financial aid programs do exist to help students and their parents pay for college—and, in some cases, private elementary and secondary school. Grants, loans and other forms of assistance are available to help make the cost of college more manageable, especially if you are middle-class or poor. But the fact remains that for most families, college will be expensive, even with the contributions of financial aid programs. Careful financial planning is essential if you are to have the resources available to meet your kids' educational costs.

One excellent way to fund your children's college educations is through life insurance. Let me share with you two beneficial strategies:

Strategy #1: Buy a Whole Life Policy on Yourself after Your Child is Born

This should be a plan that builds cash value rapidly or very rapidly. The size of the death benefit depends on your particular needs and circumstances, but for this strategy I generally suggest a high-cash-value,

low-death-benefit policy. Your policy should also include a disability waiver of premium rider.

When your child goes off to college, continue paying premiums on your policy. But also begin borrowing against it to pay your child's college costs as they arise. Don't surrender any of your paid-up additions—just borrow. *This will enable you to send your child to college without spending any additional out-of-pocket dollars during his or her college years.* With proper planning, this arrangement can use triple-duty dollars to provide your child with an education under virtually any circumstances. Consider the following three possibilities:

1. If you are alive and healthy when your child reaches college age—as you certainly hope and plan to be—your policy will have ample cash value to borrow against.
2. If you die before your child reaches college age or while he or she is attending college, the child (or the trust you have set up in his or her name) will receive the full life insurance death benefit, which will be more than enough to pay all of the college expenses.
3. If you become disabled for a significant length of time, the disability waiver of premium rider will allow you to continue your policy in force without paying premiums. The cash value and death benefit will continue to grow as if you had not become disabled.

The result is that no matter what happens to you, you have provided for your child's college education.

Strategy #2: Buy a Whole Life Policy on Your Child after Your Child Is Born

If you already own 100 percent whole life or universal life coverage on yourself and that coverage provides all the death benefit you need, there is a second alternative. Soon after your child is born—or as soon as your own life insurance needs have been completely met—buy a whole life policy *on your child* from an excellent, well-managed life insurance company. (You can set up such an arrangement at any time; but the older your child is when you buy the policy, the higher your premiums will need to be for this strategy to be effective.) Name *yourself* as the beneficiary of the policy. Because the main purpose of the policy is to build cash rather than to provide a death benefit, buy a policy with the highest cash value and the lowest legally permitted death benefit that you can.

When your child sets off for his or her freshman year as a college student, begin borrowing against that policy to pay your child's college costs as they are incurred. Again, don't surrender any paid-up additions; simply borrow. If you have planned properly

and the policy performs reasonably close to its original projections, then you should be able to do this for four years without reaching the policy's borrowing limit.

During these four years, continue paying premiums on the policy. This ensures that the cash value in the policy will continue to grow steadily throughout your child's college years—probably by a great deal more than you are paying in premiums each year.

In both of these strategies, you will have to pay annual interest on any outstanding loans; but if you have planned well, there should be enough cash in the policy to enable you to borrow the cost of interest each year, if you like. So, after four years, if all goes as planned, all of the following have taken place:

- Your child has graduated from college.
- You have managed to pay for your child's entire college education without coming up with a single extra dollar out of your pocket during his or her college years.
- You own a life insurance policy with large, steadily growing cash values, which you can continue to keep in force or, if you prefer, surrender for cash (along with any paid-up additions) when your child graduates.

Furthermore, *throughout much or all of your child's life, you have gained a number of benefits as well:*

- You have a ready source of cash for opportunities and emergencies.
- You have a source of equity to borrow against at favorable rates, no questions asked.
- You have continuous life insurance coverage on your or your child's life.

Furthermore, if you followed Strategy #2 and your child were to die before he or she went to college, you would receive a death benefit. This would normally be sufficient to pay most or all of the cost of sending one of your other children to college.

And with either strategy, if your child drops out, graduates in less than four years, decides to get only an associate's degree or doesn't go to college at all, you've lost nothing. You've still gotten all of the benefits just described, including the steadily growing cash value.

Once your child is no longer in school (or if he or she chooses not to go to college), you have several options. You can use the policy to build cash for your retirement and/or other purposes. You also have the choice of either repaying the loans over time to restore the maximum cash value and death benefit, or letting the principal remain unpaid and simply paying the annual interest due. And there's another set of choices: You can continue paying premiums out of your pocket, or you can institute a vanishing premium scenario.

If you have followed Strategy #2 and bought a life insurance policy on your child, you have yet *another* option. When your child graduates, why not give him or her the policy (including its accumulated—and by now very rapidly growing—cash value) as a graduation gift? You can formally transfer ownership of the policy to your child, and he or she can then make the future premium payments, each of which will be far outweighed by the annual increase in cash value. The child can also, if he or she wishes, choose a new beneficiary.

I also strongly recommend showing your child how he or she can repay the loans against the policy over the years so that the policy is as useful and valuable as possible. Actually sit down with your child and set up a repayment schedule; if his or her own finances are limited, you may want to make some of the loan payments yourself during the first one to five years.

Benefits of Transferring Policy Ownership to Your Child

If you transfer ownership of a life insurance policy to your child, you accomplish several things.

- You teach him or her financial responsibility and some of the basics of financial planning.
- You give him or her an enormous financial head start in beginning a career and/or a family.
- You provide him or her with a source of equity for borrowing against in emergencies, or for special projects or opportunities.
- You provide him or her with life insurance coverage at a low price. This coverage continues regardless of your child's health. Furthermore, he or she does not have to pass a medical exam or answer any health questions.
- You give your child a vehicle that *automatically* builds cash value quickly and steadily—far, far faster than cash is put into it.
- You provide your child with an in-place, already functioning program for building cash to buy a home, start a business, get a graduate degree, put his or her own kids through college or fund your child's own eventual retirement. This program has significant cash value already built up in it, *and* it has large tax advantages.

To transfer the ownership of the policy to your child, simply speak with your agent. This is a simple administrative matter and can be handled by filling out a short form.* And if you don't want to transfer ownership of the policy (e.g., if you have doubts about your child's maturity or financial stability), you can hang onto it yourself. Simply continue making the payments

on your own and enjoy the benefits of the steadily growing cash value. You can use the policy to build cash for your own retirement or for some opportunity of your own. And if your child should die prematurely, the death benefit (less any outstanding loans) goes to you.

USING LIFE INSURANCE FOR CHARITABLE GIVING

Most of us have at least a handful of causes to which we're willing to give some of our hard-earned money. But most people don't have the financial wherewithal to contribute as much or as often as they'd like. Furthermore, it can often be difficult to choose between making a charitable contribution to an organization you care about and buying a luxury you and your family have had your hearts set on for some time.

One innovative and very inexpensive solution to this dilemma is to make life insurance a key component of your charitable giving. One of the best—and most overlooked—features of life insurance is that it can enable a middle-class individual or family to make a truly major contribution to charity *without spending much money*. By using life insurance creatively, it is possible for a typical middle-class person to make a charitable contribution of a *quarter of a million dollars* at an out-of-pocket cost of *only \$80 a month*.

This may seem next to impossible at first. Rest assured, however, that not only is it quite possible, but life insurance companies make a decent profit in the process. Here's how it all works: Let's suppose that you've long admired the work of an imaginary organization, which we'll call the Dearborn Foundation. You'd gladly give the foundation \$250,000 if you had it to spare, but since your job pays only \$47,000 a year and you've got a spouse and two kids, you can reasonably afford to contribute only between \$1,000 and \$2,500 a year.

Now, you can simply send that money straight to the foundation each year if you like. But let me suggest an alternative: Use that same money to pay for a high-death-benefit, very-low-cash-value whole life policy—or, if you want to keep the premiums absolutely as low as possible, a blend. For \$2,500 a year or less (depending on their age, life-style and health), many people can get a low-cash-value whole life policy with a \$250,000 guaranteed death benefit from a first-

* In general, you can always transfer ownership of any life insurance policy to the person covered by a policy, or to anyone who has an *insurable interest* in that person. In practice, this means any immediate relative (mother, son, sister, etc.), grandparent or grandchild, guardian, employer or other person or organization that will suffer a significant emotional or financial loss if the insured person dies.

rate carrier; for less than \$1,000 a year, they can buy an inexpensive blended policy with the same death benefit.

You can set up your policy in either of two ways. First, you can own the policy yourself, make regular payments on it and name the Dearborn Foundation as your beneficiary. When you die, the Dearborn Foundation will get a check for at least \$250,000 from your life insurance company. If you buy a whole life policy or a level term blend, the death benefit will steadily increase as the years pass. In fact, if you buy a \$250,000 whole life policy in your twenties and live to be 80, the death benefit could easily increase to over \$2 million by the time you pass away. Under this arrangement, the cost to you each year is limited to your premium payments, but the ultimate financial benefit to the charity you've chosen is enormous.

Keep in mind, too, that every dollar of the death benefit will go straight to the foundation. No one—you, and not the charitable organization named as your beneficiary—ever has to pay a penny of income or estate tax on it. On top of all this, *you* own the cash value in your life insurance policy. You can borrow against it whenever you wish. And if at any time you change your mind about making the Dearborn Foundation your beneficiary, simply change it to some other organization, person or group.

This probably sounds pretty good. But let me suggest a second scenario, one that further enhances the power of every charitable dollar you spend. Instead of owning a policy on yourself and naming the Dearborn Foundation as your beneficiary, arrange with the foundation—and with your life insurance agent—for the foundation to be *both the beneficiary and the owner* of the policy. Under this arrangement, the cash value in the policy belongs to the foundation, but you pay the premiums. But you don't just mail those premiums to the life insurance company. Instead, *you make regular gifts to the foundation* that are equal to the cost of the policy premiums. The foundation, in turn, uses your gifts to pay those premiums.

For example, suppose you decide to spend \$1,000 a year on a \$250,000 level term blend. You arrange with the Dearborn Foundation that it will own the policy, be the beneficiary of the policy and be formally responsible for paying the premiums on it. Each year, shortly before the annual premium is due, you make a gift of \$1,000 to the foundation. The foundation then takes this \$1,000 gift and pays the annual premium with it. *This arrangement enables you to take a \$1,000 tax deduction for a charitable contribution every year.* When you die, the foundation gets the full death benefit of at least \$250,000. The older you are when you die, the more money the foundation receives.

These two scenarios make it possible even for people of modest means to make a major financial contribution to any cause they believe in. But note that the

strategies for charitable giving just described are frequently not as effective with term policies as they are with other forms of life insurance. Why? Because, as you'll recall, term plans have no value until you die. At the same time, however, they get steadily more expensive as you get older. This means that if you make your favorite charity the beneficiary of your term policy, you may end up canceling your policy before you die because the premiums have become prohibitively expensive. If you do this, the charity gets nothing.

OTHER FINANCIAL PLANNING TIPS

Here are some other things to consider when developing a financial plan that includes life insurance.

Dollar Cost Averaging

One essential consideration for any financial plan is keeping up with inflation. Perhaps the best way to offset inflation—and to keep pace with any growth in your income or monthly expenses—is to *dollar cost average* your life insurance premium outlay. This simply means to put a certain fixed percentage of your income into life insurance. I usually recommend 10 to 15 percent, but this can vary widely, depending on your specific needs, goals and circumstances.

For example, let's say that five years ago you bought your first life insurance policy, a \$250,000 whole life plan. Back then you were making \$35,000 a year. Today, though, you're making \$57,000 a year. And in the past five years, both your cash value and your death benefit have grown significantly. But during that same time, the value of the dollar has also shrunk because of inflation. While you have exactly the same *number* of dollars in cash value and death benefit that your initial policy illustration predicted, the *spending power* of each of those dollars is smaller than it was five years ago. The best way to adjust for this is to purchase additional coverage—in this case, perhaps another \$100,000 worth of whole life insurance.

If you own a universal life or universal term policy, you also have the option of adjusting for inflation by simply increasing the death benefit of the policy (and, in the case of a universal life plan, increasing your cash value as well). This will cause your premiums to go up, of course.

Whenever you wish to add to or increase your coverage, you may need to provide evidence of insurability. This means passing a medical exam, providing satisfactory answers to a series of health questions, or both. However, if you have purchased a *guaranteed increase option* as part of your policy, you have the right to increase your coverage *automatically* at certain speci-

fied times, without providing evidence of insurability. You do, of course, still have to pay larger premiums for the increased coverage. (See p. 88 for details on this important and very useful feature.)

Flattening Your Tax

Most people lose sight of the tax implications of their investments. For example, let's say you've got \$20,000 in a mutual fund, and last year that fund paid you 9 percent interest on your money. You may think that you've made \$1,800, but you really haven't, because *your earnings from that investment are subject to federal (and, in most cases, state) income tax*. The tax you pay on that \$1,800 of income isn't really income; it's just money that passes through your hands on its way to the state and federal governments. So your 9 percent interest, after tax, might actually be 7 percent interest.

Furthermore, with most investments, *you must pay tax on interest as it is earned*, even if you don't spend the money you've made. In the previous example, you may now have \$21,800 instead of \$20,000 in your mutual fund, but by April 15 you have to pay tax on that \$1,800—and, unless you withdraw money from the fund to pay that tax, you'll have to pay it out of your pocket. In other words, *you may have to spend money out of your pocket when you make money from your investment*. Earning that 9 percent interest that you plan to spend in the future costs you hard cash *now*.

What's worse, this happens *every year*. And the longer you let the assets in most investments accumulate, the more tax you must pay. Each year your income tax bill gets bigger—and if you're like plenty of other people, each year you pay that ever-increasing tax bill out of your pocket. Let me put it bluntly: When you leave money in the bank or in an investment to accumulate interest, you're not only compounding the interest, *you're compounding the tax as well*.

Life insurance provides an excellent solution to this problem. Instead of compounding your income tax every year, why not consider flattening the tax? If you're getting a good rate of return on an investment

or in the bank, go ahead and leave the principal there. But each year, instead of leaving the interest untouched and compounding the tax on it, *take out* that interest. Use part of it to pay the tax that's due, and put the rest into a tax-sheltered vehicle: whole life insurance from a first-rate carrier.

What are the benefits of this strategy? First, you reduce the amount of tax you must pay the state and federal governments because you've taken it out of a fully taxable investment and put it into a cash accumulation vehicle that has distinct tax advantages. (Remember that if your policy is properly managed, you can make use of every dollar of cash value in it without paying a penny of tax.) Second, you've put your money into a vehicle that should yield excellent cash accumulation over the long term. And third, you've got the benefit of life insurance coverage, which provides your beneficiary with a sizable death benefit when you die.

Why not make use of this triple advantage? And, for heaven's sake, why pay any more tax than you have to?

Disability Coverage

A disability policy pays you a steady, monthly sum of cash if you become disabled and unable to work. Most individuals and families need disability insurance just as much as they need life insurance coverage.

The purpose of disability insurance is to provide you and your family with financial support in the event of a serious and prolonged injury, illness or other health problem. In many cases, disability insurance has made the difference between financial stability and financial distress—or even financial ruin.

A detailed discussion of disability insurance is beyond the scope of this book. However, the vast majority of life insurance agents also sell disability coverage. It may be very important (if not crucial) that disability coverage be included as a part of your overall financial plan. Talk to your agent about disability insurance and ask if he or she honestly feels that it is necessary or appropriate for you.