

# Chapter 5

## Whole Life Insurance—A Closer Look

Walt Disney was a visionary whose dreams became concrete realities, realities that remain part of Americana more than 50 years after his passing. A filmmaker who won 22 Academy Awards, he created animated jewels like Snow White, Bambi, Pinocchio and Fantasia - each with a richness of color and attention to detail that even today’s computer-generated pictures cannot match. His characters, Mickey and Minnie Mouse, Daisy and Daffy Duck, Pluto and Goofy, captivated generations of children, their charm never growing old. He pioneered the theme park concept, first with Disneyland in California and later with Disney World, which turned Orlando, Florida from a sleepy, citrus growing town, to a 2 million plus population metropolis with more entertainment attractions than anywhere else in the world.

Like all entrepreneurs, Walt had financial challenges along the way. Disneyland, which opened in 1955 with future president Ronald Reagan officiating, was a \$17 million project that stretched his wallet to the limit. According to Walt, to open his park, he “had everything mortgaged, including my personal insurance.”

Similar stories can be told of other iconic business names. It is said that when McDonald’s was in its early years, Ray Kroc borrowed against his whole life policies to meet payroll. And James Cash Penney, otherwise known as J.C., used cash from his whole life policies to keep his company afloat after the Great Depression.

Cash-rich whole life policies were an investment mainstay for our parents’ generation, providing financial stability and wealth accumulation. The tax favored slow but steady cash value growth provided a long-term investment option for Americans saving for their golden years and the tax-free death benefit provided security along the way.

We, at ITM TwentyFirst, often encounter whole life policies taken out many years ago with annual cash value growth that exceeds 4%. For example, the chart that follows is from a 66-year-old whole life policy we manage with the dividend paying the premium. In calendar year 67 the ending cash surrender value is \$108,399. The next year, calendar year 68, the cash surrender value is \$113,292.

End of Year	Insurance Death Benefit	Dividend	Annual Premium Outlay	Cash Surrender Value Increase	Cash Surrender Total		
66	127,334	3,657	0	NA	103,680	CV Year 67	108,399
67	131,499	3,833	0	4,719	108,399	CV Year 67	113,292
68	135,829	4,010	0	4,893	113,292	Difference	4,893
69	140,318	4,183	0	5,061	118,353	CV Growth	4.51%

The 4.51% annual cash value increase is a very respectable return for a fixed investment, especially in a low interest rate environment. The increase illustrates why whole life insurance was (and still is to some) considered to be a secure and practical, though not very glamorous, financial product. But in the TOLI world, the rate of return on the death benefit provided is often more important than cash value growth in a policy, and we have seen the use of whole life insurance fall over the years in TOLI trusts. In our TOLI Survey we found that a decade ago whole life insurance made up about 40% of the life insurance we saw in the TOLI market. Today that figure has dropped to 30% (2).

## Dividends

Guarantees are one attraction of a whole life policy. If the premium is paid each year, the death benefit is guaranteed, and the policy is guaranteed to endow (cash value equals the death benefit) at maturity. Besides the guaranteed cash value in a participating policy a dividend is also paid on the policy. Dividends are not guaranteed and are driven by the operating performance of the company. The guarantees in the policy are based on very conservative assumptions for investment returns, mortality, and expenses. However, it is assumed that the actual performance of the policy will surpass the guaranteed outcomes. When that occurs, a divisible surplus is created out of which a dividend is paid.

Each year, The Board of Directors approves the payment of dividends and declares the dividend interest rate (DIR), which is the investment component of the dividend. The dividend is based on the performance of three components.

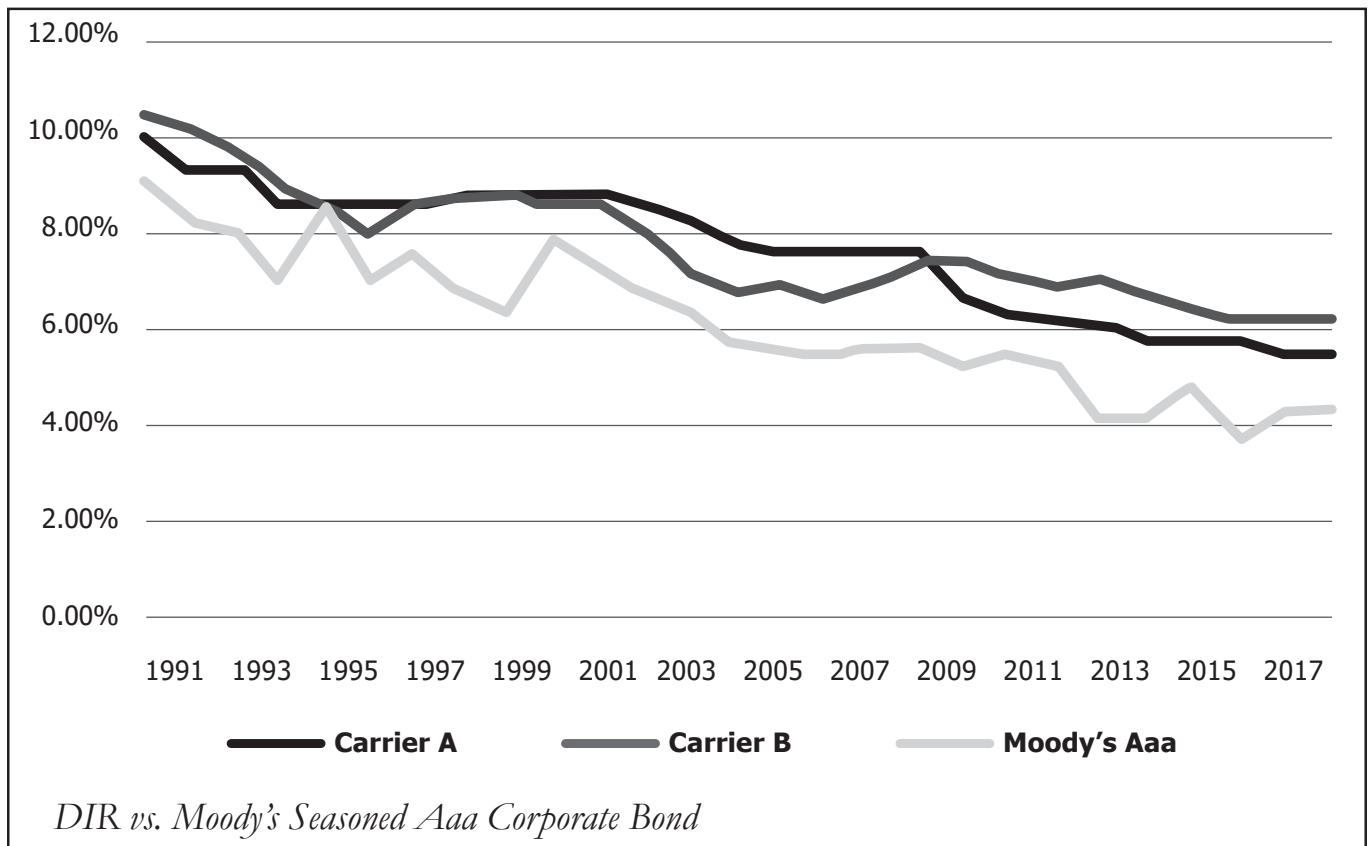
1. **Investment Results:** The interest rate portion of the dividend, the DIR, is declared by the carrier annually based on the actual rate of return generated from the investment portfolio versus the underlying guaranteed return on the policy. As we illustrated in the Average General Account Portfolio chart in Chapter 4, the cash value of a whole life policy is invested in fixed instruments, primarily high-grade bonds and mortgages. These fixed instruments tend to have little year to year volatility with interest rates rising and sliding slowly over time. However, over the last two decades, as can be seen in the Dividends for a Major Whole Life Carrier chart in Chapter 4, rates have dropped consistently and now stand at or near historic lows.
2. **Mortality:** When there are fewer death claims than projected, there is a savings in the mortality that will affect the dividend positively.
3. **Operating Expenses:** When the operating expenses of the company are less than anticipated, those savings will affect the dividend positively.

What is the difference between a participating and non-participating policy? A participating policy is one that pays a dividend, the policy participates in the “profits”, technically the surplus earnings, of the company. Typically, participating (par) policies are offered by mutual companies and non-participating (non-par) policies are offered by stock companies, though they can offer par policies.

What is the difference between a mutual and a stock life insurance company? A mutual company is “owned” by its policyholders. A stock company is owned by its stockholders. In a mutual company a portion of the profits earned are returned to policyholders, in a stock company the profits are distributed to stockholders.

Carriers are very proficient in the art and science of underwriting an insured. Mortality tables provide a basic estimate of annual death claims, but each carrier also has internal data and guides that allow them to refine estimates. It is rare that a carrier will underestimate the mortality costs of a portfolio of policies, nor will the actual results deviate too far from expected. In many instances, larger policy death benefit liabilities are shared with re-insurers, thereby limiting the carrier's exposure. Most carriers tightly control operating expenses, and though costs can differ from carrier to carrier, most carriers' expenses are not far out of line with their expectations. In a whole life policy, both mortality and operating expenses are predicted very conservatively and generate savings greater than expected which are passed on to policyholders. The component that most affects the changes in the dividend paid is the investment return. Since a large portion of the investments in a whole life policy are in high quality bonds, the DIR will generally track the benchmark of a portfolio of long term bonds like Moody's Aaa Long-Term Corporate Bond Yield Average. As can be seen in the chart that follows, the historical whole life dividends for two top mutual carriers over the last 25 years generally follow the Moody's Aaa Bond Average (3), with the DIRs tracking slightly above.

### Information From Moody's



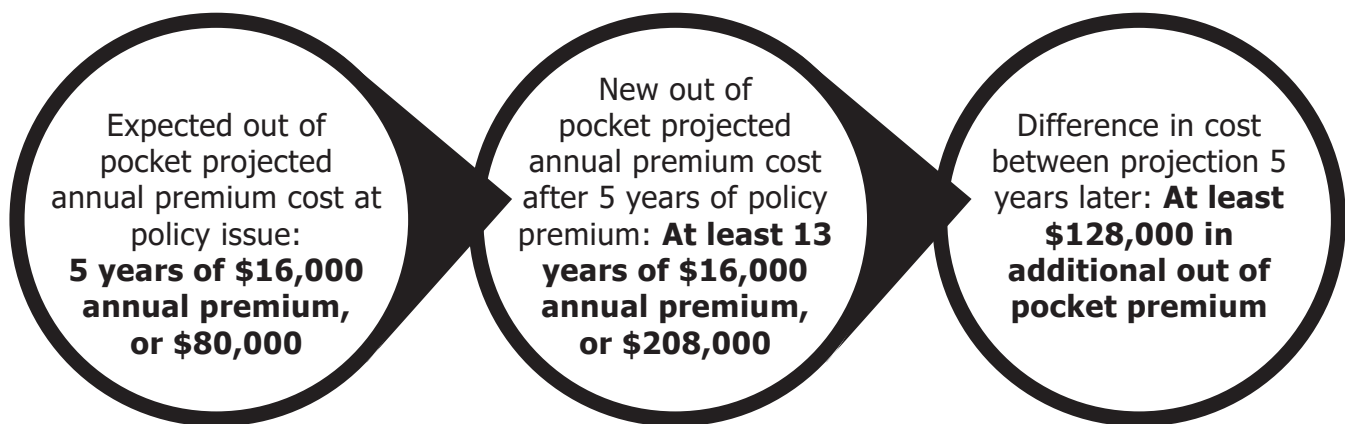
Both bond index and carrier DIR returns have sloped downward over the last 25 years. In most instances, the mortality and expenses for whole life policies have been favorable relative to expectations, but the low interest rate environment has negatively affected carrier investment returns causing policy performance to falter.

As with all permanent life insurance policies, an as sold illustration is provided at policy issue, which projects the current policy expectations over the lifetime of the insured. As we mentioned, if a whole life policy premium is paid in full each year, the policy provides guaranteed cash values that will allow the policy to endow at maturity. However, rarely is a TOLI policy fully funded. Typically, the dividends are used at some point to reduce the premium, and eventually eliminate out of pocket contributions.

## Declining Dividends Lead to Disappointment

A sales technique, called “vanishing premium,” was based on non-guaranteed sales illustrations showing that in a certain number of years the dividend would be sufficient to pay the entire premium on the policy, lowering the overall premium costs. The strategy was used to entice prospects to buy whole life policies, but because of the dividend drop, the strategy often failed, with additional premiums due.

The disappointment felt by whole life consumers who purchased vanishing premium policies led to numerous lawsuits against carriers, including New York Life, Prudential, Metropolitan, Transamerica, John Hancock, Great-West and Jackson National, with settlements of up to a billion dollars reached (4). The chart below shows the projected outcome that was assumed on a whole life policy at issue contrasted to the policy’s actual performance. This example was part of a lawsuit against Merrill Lynch as trustee of an ILIT. A Merrill Lynch adviser had sold a \$1 million Manulife whole life policy with the expectation that only 5 years of premium payments would have to be paid out of pocket. The balance of the premium costs was to be paid “by dividends generated by the Manulife policy or by surrender of PUA (paid-up additional insurance).” After paying premiums for 5 years, the grantor/insureds were told that “cash premium payments would be required for at least thirteen years before the premium payments would vanish.” The difference in cost was substantial, and the grantors filed a complaint for “breach of fiduciary duty, negligent misrepresentation, fraudulent inducement, fraud and negligent supervision arising out of the sale” (5).



*Vanishing Premium Scenario, Koehler v. Merrill Lynch, District Court of Florida, 1998*

The vanishing premium problem was investigated by Congress in 1994, and listed as one of “the eight biggest rip-offs in America,” in a cover story in a popular financial magazine (6). The lesson learned for a TOLI trustee? Since dividends are not guaranteed, any premium suspension funding strategy should be monitored and adjusted as needed, with written grantor acknowledgment of any changes.

## Funding a Whole Life Policy

If the premium on a whole life policy is paid in full, the entire dividend can be used to purchase paid up additions, small policies within the whole life contract that add death benefit and cash value to the policy. A much higher cash value and death benefit will be generated in a fully funded policy with dividends purchasing paid up additions, rather than reducing the premium. The spreadsheet that follows shows the projected outcome of a 20-year-old whole life policy purchased on a 62-year-old. The projected outcome assumes annual out of pocket outlay is suspended in the 20th year (Option 1) or is paid all years (Option 2). Column 5 shows zero out of pocket outlay assuming the premium suspension option, with Column 3 showing the death benefit of the policy, and Column 6 showing the total cash surrender value utilizing that option. Column 9 shows the payment of the full premium payment (\$21,090), with Column 7 showing the death benefit, and Column 10 showing the total cash surrender value of the policy assuming the full premium payment option. The total cash surrender value shown includes the guarantee cash value plus the additional cash generated from the dividends paid.

		Option 1 - Assumes Premium Suspension				Option 2 - Assumes Full Premium Payment			
Column 1	Column 2	Column 3	Column 4	Column 5	Column 6	Column 7	Column 8	Column 9	Column 10
Policy Year	Insured Age	Death Benefit	Dividend	Annual Out of Pocket Outlay	Total CSV	Death Benefit	Dividend	Annual Out of Pocket Outlay	Total CSV
20	82	1,300,000	21,009	0	760,167	1,322,672	21,998	21,090	793,456
21	83	1,311,409	21,689	0	786,094	1,358,453	23,895	21,090	833,138
22	84	1,311,188	22,456	0	812,264	1,384,432	26,177	21,090	885,508
23	85	1,311,772	23,332	0	838,623	1,413,181	28,958	21,090	940,032
24	86	1,313,275	24,188	0	865,090	1,444,962	32,232	21,090	996,776
25	87	1,315,678	24,953	0	891,556	1,479,912	34,873	21,090	1,055,791
26	88	1,318,883	25,664	0	918,028	1,518,107	36,872	21,090	1,117,252
27	89	1,322,836	26,144	0	944,172	1,559,673	38,660	21,090	1,181,010
28	90	1,327,292	26,799	0	970,971	1,604,564	40,517	21,090	1,248,243
29	91	1,332,436	27,655	0	998,626	1,653,175	42,419	21,090	1,319,365
30	92	1,338,478	28,854	0	1,027,480	1,705,945	44,431	21,090	1,394,946
31	93	1,345,780	30,427	0	1,057,907	1,763,478	46,509	21,090	1,475,605
32	94	1,354,734	32,328	0	1,095,686	1,826,431	48,513	21,090	1,567,383
33	95	1,365,683	34,728	0	1,136,066	1,895,429	50,455	21,090	1,665,813
34	96	1,379,152	37,997	0	1,179,934	1,971,301	52,544	21,090	1,772,083
35	97	1,396,054	41,029	0	1,227,067	2,055,286	55,292	21,090	1,886,299
36	98	1,416,140	43,541	0	1,276,961	2,147,486	59,486	21,090	2,008,308
37	99	1,438,863	47,822	0	1,331,407	2,247,731	66,226	21,090	2,140,276
38	100	1,466,081	54,568	0	1,392,905	2,358,286	76,588	21,090	2,285,111

This policy was already well funded. The premium was paid in full for 19 years and the policy was started with a 1035 Exchange amount.

Some items to note:

1. The dividend paid dropped when the policy premium was suspended (Column 4 vs. Column 8). All else equal, the dividend for a whole life policy will decrease if the policy premium payment is stopped or a policy loan is taken. The divisible surplus is divided amongst all policies based on their contribution to the surplus, and a fully funded policy is deemed to have contributed more.

2. Since the policy is well funded, the death benefit will still begin to increase when the insured reaches the age of 83 (Column 3) even though the dividend is paying the premium. This is because the dividend (\$21,689) at that point is greater than the premium (\$21,090), so the balance goes to purchased PUA. However, Column 7 shows the death benefit increasing by a greater amount as the full dividend is used to purchase paid up additions since the policy is fully funded by out of pocket contributions.
3. At age 100 - maturity, the fully funded policy (Option 2) has \$892,206 in additional death benefit (Column 7 amount of \$2,358,286 minus Column 3 amount of \$1,466,081). However, the additional premium paid into the fully funded policy over the nineteen years equals \$400,710 (19 years multiplied by Column 9 annual premium amount of \$21,090). The increasing death benefit more than keeps pace with inflation and represents an approximate 7.5% return on the additional premium paid. Even without out-of-pocket premiums, the Option 1 policy would have run to maturity, and the death benefit would have grown (Column 3). As trustee, you must decide if the outcome would be more beneficial if out-of-pocket premiums were discontinued. Each case is driven by the specific facts and circumstances, but a decision should be made. A policy should not be funded blindly, there should be a plan and it should be noted in the trust file. Remember the goal is to maximize the benefit to the beneficiaries.

Considering the above example, one could argue that continuing to fund the policy at a 7.5% return is a reasonable return on a fixed product. However, there will be times when it does not make sense to continue funding a cash-rich whole life policy. If the policy cash value is not important then you need to review whether the death benefit can be sustained until maturity without additional out-of-pocket premium payments and whether the additional premium payments increase the death benefit in the policy. We have reviewed mature policies where additional funding did not generate a sufficient additional death benefit to warrant the expense. Each situation will be different and you must review your options, remembering that dividends can, and will, fluctuate.

## APL Traps

An underfunded whole life policy must be handled with caution. As mentioned, one of the uses of a dividend is to reduce the out-of-pocket premium. However, if the dividend is insufficient to pay the premium and no other funds are available, the policy can be paid by an automatic premium loan (APL). The APL is a provision in a whole life policy that provides a loan from the policy's cash value to pay the scheduled premium automatically if the premium remains unpaid after the due date. The loan carries an interest charge, but keeps the policy from lapsing or falling into one of the non-forfeiture options.

There are two traps a trustee can fall into when an APL is used to pay the premium. The first is assuming the policy has one when it does not. Most whole life contracts contain the APL feature, but it might have to be chosen at policy issue, a simple checking of a box in an application. Occasionally, that is not done, and a policy is issued without the

APL feature. If a policy does not have the APL feature, it can lapse and go into one of the non-forfeiture options available (see box to the right). As the trustee on the policy, any of the options would more than likely reduce the specified death benefit to the trust, leaving the trustee potentially liable. On all whole life policies, you should confirm the existence of an APL provision as part of the onboarding process.

### What are the Non-Forfeiture Options?

Designed to ensure that the policyholder receives some benefit when a policy lapses or is surrendered, the three options are:

1. Cash Surrender—The policy owner receives a check for the cash surrender value of the policy.
2. Reduced Paid-up—The policy cash value purchases a contractually guaranteed paid-up policy at a lesser death benefit than the existing policy, but needing no additional premium payments.
3. Extended Term—The policy cash value purchases a term insurance policy in an amount equal to the original policy's face value, however, for a specified period, typically less than the insured's life expectancy. When the term insurance expires, there is no more death benefit coverage.

### Example of a taxable event as the result of a loan squeeze lapse

Assume a grantor purchased a \$1M whole life policy for his ILIT twenty years ago. The fixed annual premium is \$25,000. The grantor pays the premium for 7 years, then allows the APL to pay the premium for the next 13 years, at which time the policy experiences a loan squeeze. The trustee, as the policy owner, receives a premium payment notice to avert a policy lapse. If the policy lapses, any gain in the policy is taxable at ordinary income tax rates. An outstanding loan is generally treated as an amount received if a policy is surrendered or lapsed. Gain is defined as amount received from the policy minus the net premium cost. Net premium cost is the total premiums minus any tax-free distributions received. In this case, there would be no surrender value received from the carrier as the loan is greater than the cash value of the policy. When the policy lapses there would be phantom income created because the loan on the policy is forgiven, creating a taxable amount due.

Total Premium Paid: \$175,000

Minus Loan Received: \$326,251

Taxable Amount: \$151,251 (difference between Premium Paid and Loan Received)

Taxes Due (assuming 30% tax rate): \$45,375

A policy lapse caused by a loan squeeze can create a taxable event, a real issue in an unfunded trust. Even if you continue to fund a policy with a large loan to avert the lapse, the outcome is not always economically attractive, as can be seen in the case study below.

## Case Study: What Would You Do?

SCENARIO: A newly onboarded trust was being readied for a first-time premium payment. The sixty-five-year-old grantor contacted the trust administrator concerning the policies in the trust, four whole life policies with a total death benefit of almost \$1.7 million that had been in force for almost 20 years. The grantor was informed by his agent that the policies did not need any additional premium payments. The grantor informed the administrator that no gifts would be made to the trust, stating that “the policies I have are self-sustaining,” since his agent told him, “the premium and the interest due can both be paid by values in the contract.”

Column 1	Column 2	Column 3	Column 4	Column 5
Year	Age	Annual Required Premium	Cumulative Required Premium	Net Death Benefit
1	65	0	0	1,697,987
2	66	0	0	1,635,750
3	67	0	0	1,584,096
4	68	2,135	2,135	1,535,824
5	69	2,354	4,489	1,489,269
6	70	3,195	7,684	1,442,493
7	71	4,387	12,071	1,395,790
8	72	5,096	17,167	1,349,613
9	73	5,673	22,840	1,302,678
10	74	6,387	29,227	1,253,792
11	75	7,194	36,421	1,222,598
12	76	7,903	44,324	1,194,054
13	77	8,344	52,668	1,163,840
14	78	9,650	62,318	1,132,549
15	79	11,345	73,663	1,099,103
16	80	13,245	86,908	1,063,306
17	81	14,352	101,260	948,873
18	82	16,134	117,394	908,721
19	83	18,745	136,139	866,071
20	84	21,943	158,082	823,289
21	85	23,415	181,497	780,071
22	86	26,340	207,837	734,921
23	87	45,673	253,510	709,430
24	88	49,043	302,553	687,145
25	89	51,285	353,838	663,394
26	90	54,734	408,572	638,607
27	91	58,342	466,914	612,963
28	92	62,135	529,049	584,319
29	93	65,790	594,839	552,938
30	94	67,394	662,233	517,541
31	95	68,930	731,163	475,838
32	96	71,293	802,456	430,912
33	97	73,654	876,110	380,659
34	98	78,403	954,513	329,600
35	99	65,392	1,019,905	274,418

Even as the Cumulative Required Premium increased (Col.4), the Net Death Benefit (Col.5) decreased



**REVIEW:** The policy analysis above found that if no more out-of-pocket contributions were made to the policies over the next three years, the loans already on the policies would cause a loan squeeze. Contributions would have to be made to the portfolio to pay at least the interest on the loans or the policies would lapse one by one, with each lapse causing a taxable event.

In four more years, a minimal amount would have to be paid to support the policies, but within 10 years the cumulative premium paid would reach almost \$30,000 (Column 4) and each year thereafter the amount would grow with a spike occurring at age 87, 23 years out. Since the required payments on the policies would be just enough to keep the policies from lapsing, the trust death benefit would drop as the loan grew. If the grantor lived to age 90, the total net death benefit in the trust was projected to drop to \$638,607, even after paying the minimum required cumulative payments of \$408,572.

Another alternative for the trust would have been to take paid-up policies in the first year which would not have triggered a taxable event but would have lowered the death benefit in the trust to approximately \$600,000. However, the death benefit would have been guaranteed with no more premium payments.

**OUTCOME:** The future policy lapse and negative taxable event for the trust was discovered before it was too late. But a decision would have to be made. Take the \$600,000 death benefit now or continue knowing additional premium would have to be paid?

## **Blending a Policy with Term Insurance**

Whole life policies can be blended with a term insurance component, which lowers the premium cost. As you would expect, there is a trade-off. A blended policy is designed so that the term portion is converted to base insurance coverage over time. The cost of the term portion of the policy will increase as the insured ages. If the term component of the policy is not converted, the death benefit coverage may have to be reduced, or premium costs will increase substantially. If policies are funded poorly, or the term blend is very high, the likelihood of this occurring increases. When dealing with blended policies it is important to look ahead, as these issues tend to come in the later years and you must make grantors aware of any issues well before they arise. If the insured passes away before the problem emerges, there will not be any liability. However, there are times, especially in an underfunded policy on an older insured, where problems will occur. When managing life insurance, you must be able to spot developing issues like this well before they become a problem.

As mentioned, the use of whole life as a TOLI policy has dropped over the years while universal life, especially guaranteed universal life, has gained favor. However, there are still many whole life policies in TOLI portfolios.

**For the whole life policies in your portfolio the following are some practices that should be employed:**

- When taking in a policy, review the automatic loan (APL) provision to ensure that it is currently in force.
- In those situations, where an APL is used, make sure the policy will not become over-loaned, creating a loan squeeze. It is important to review a policy with a loan annually, keeping the later years in focus as that is when most issues tend to occur.

- For policies with a term component, make sure the policy is adequately funded. This will ensure that the term component is converted over to base whole life, which will alleviate any premium spikes and/or loss of the death benefit in the later years.
- Unless there are reasons (for example, income distributions) for developing significant cash values, it is key to review the policy funding, dividend election, and loan usage, to maximize the internal rate of return on the policy death benefit. While it is important to ensure that the policy will mature and pay the entire death benefit, the premium payment, especially in the later years, may not be necessary to reach policy goals.