

16 reasons why accountants prefer indexed universal life to mutual funds

By Allen Koreis

It's not just about the death benefit.

Have you heard about the remarkable savings vehicle that offers the appeal of market-linked gains without the worry of market-based losses? Your accountant certainly has, and he or she is beginning to weigh in on their many benefits, guarantees and tax advantages.

Consider:

1. An indexed universal life policy account value can **never lose** money due to a down market. Indexed universal life insurance guarantees your account value, locking in gains from each year, called an annual reset.

a. During a year of growth, the IUL account value will participate in typically 100 percent or more of the underlying index gains, via linkage to the published returns of the various indices (S&P 500, NASDAQ 100, DJIA, Russell 2000, etc.).

b. During a subsequent down year, an IUL principal and accumulated gains are locked in and carried forward (annual reset) to the next contract anniversary.

c. If the markets should recover the following year, the IUL account value again participates in those gains up to a pre-determined cap (typically 12 percent to 15 percent) without having to recover from the previous year's "correction" (losses).

Not only do mutual funds not provide this safety from market declines, but an investor can lose substantial portions of both principal and past earnings during a market downturn often requiring extreme market gains just to get back to even. Because of the absence of a potential drop in account value due to market losses, IUL qualifies as a fixed product under the licensing regulations with the Department of Insurance Commissioners of all 50 states.

2. IUL account values grow **tax-deferred** like a qualified plan (IRA and 401(k)); mutual funds don't — unless they are held within a qualified plan. Simply put, this means that your account value benefits from **triple compounding**: You earn interest on your principal, you earn interest on your interest and you earn interest on the money you would otherwise have paid in taxes on the interest.

Unless held in a qualified plan, mutual fund gains are annually reportable and taxable, thus denying an investor the benefits of such three-fold compounding. Although qualified plans are a better choice than non-qualified plans, they still have issues not present with an IUL. Investment choices are normally limited to mutual funds where your account value is subjected to wild volatility from exposure to market risk.

3. There are **no limitations** on the amount that may be contributed annually to an IUL. As of the date of this article, the IRS **limits the annual contribution** to an IRA to \$5,000 annually if the account owner is under the age of 50 and \$6,000 annually if the participant's age is 50 or higher.

4. Policy owners may **access their money** from an IUL without IRS penalty regardless of age. Qualified plan withdrawals prior to age 59 1/2 are subject to a 10 percent penalty in addition to being taxed as ordinary income for the year the withdrawal is take.

Commonly, people find themselves in a situation where they need to access their savings. When this means tapping into a qualified plan, the available amount of the account value is typically reduced by 30 percent (10 percent and 20 percent withholding). Then when the tax return is filed for the year in which the withdrawal was taken, additional taxes may be due if the qualified plan owner is in a tax bracket greater than 20 percent. With indexed universal life insurance, the available account value may be accessed at any time for any reason without tax or penalty via policy loans which are not required to be repaid. 5. You control **your taxes**, not the fund manager. IULs grows tax-deferred, and is never taxed if taken in the form of policy loans. This allows owners to control precisely if, when and how much money will be taxable, depending upon their needs and circumstances.

Mutual fund owners are subject to the fund manager's annual **capital gains** distributions whether or not they redeem any shares for additional income. Many equity (stock) mutual funds have turnover rates averaging over 80 percent annually, meaning that management sells over 80 percent of their fund's holdings every year, replacing them with other stocks (and sometimes even buying the same stocks back after Jan. 1), often in an attempt to beat their category averages.

Because of this, mutual funds rarely provide the 20 percent long-term capital gains tax rate that many claim their owners might receive. The reportable gains that a mutual fund shareholder must pay taxes on each year is exclusively a function of how long the fund manager holds the underlying investments he or she purchases, and has almost nothing to do with how long the shareholder has owned his or her fund.

6. **Mutual funds** often make annual **taxable distributions** to fund owners, even when the value of their fund has gone down in value. Mutual funds not only require income reporting (and the resulting annual taxation) when the mutual fund is going up in value, but can also impose income taxes in a year when the fund has gone down in value.

When the markets take an **extended downturn** after several years of sustained growth (as they did in 2000-2002 and again in 2008), fund managers will often resort to selling appreciated stocks purchased several years earlier in order to generate gains to offset those losses. This has the effect of minimizing the fund's published loss-in-value at year end, allowing the fund to claim that it was "only" down, say, 9 percent on the year while its peer group was down an average of perhaps 17 percent.

The unsuspecting shareholder of this fund receives his Dec. 31 statement; sees his account is down 9 percent, and assumes incorrectly that "at least" he'll owe no taxes on his "loss" come April 15; three weeks later, he receives a Form 1099-Div from his mutual fund company showing several thousand dollars of reportable income.

The reason for this is that the longer-held stocks which the fund manager sold to reduce his fund's year-end loss were sold at a gain (over their original purchase price years earlier), a gain that is now reportable and taxable to the mutual fund owner even though his statement shows his account balance is down. An IUL grows tax-deferred, cannot lose value in a market downturn and imposes no annual tax reporting as it is increasing in value.

7. **IULs avoid myriad tax traps**. The ownership of mutual funds may require the mutual fund owner to pay estimated taxes. Tax-deferred accumulation

inside an IUL does not create the same tax problem. IULs are easy to position so that, at the owner's death, the beneficiary is not subject to either income or estate taxes.

The same tax reduction techniques do not work nearly as well with mutual funds. There are numerous, often costly, tax traps associated with the timed buying and selling of mutual fund shares, traps that do not apply to indexed life Insurance. Additionally, mutual fund ownership can result in the loss of tax exemptions, tax deductions, and tax credits, and mutual funds (with the exception of those held in an IRA or 401(k)) are usually subject to state and local income taxes in those jurisdictions that have such taxes. These losses do not occur with IULs and, because they grow tax-deferred, IULs are not subject to state and local income taxes during their accumulation phase.

Finally, mutual fund ownership, specifically the annual distributions made by such mutual funds, can subject the fund owner to taxation under the alternative minimum tax. The AMT always results in increased income taxes. Indexed life insurance ownership cannot trigger the AMT in the same manner as mutual funds. 8. Mutual funds may cause income taxation of Social Security benefits. The annually reported earnings from mutual funds can, in many cases, cause a retired couple's income to exceed the thresholds above which up to 85 percent of their Social Security benefits are taxed in their income bracket. The growth within the IUL is tax-deferred and may be taken as tax free income via loans. The policy owner (vs. the mutual fund manager) is in control of his or her reportable income, thus enabling them to reduce or even eliminate the taxation of their Social Security benefits.

9. Mutual funds create an income tax trap for individuals purchasing funds late in the year. Because mutual funds must distribute realized gains to fund owners each year, fund companies usually do so in November or December. An uninformed investor purchasing such a fund during the last quarter of the year may place himself at a disadvantage by taking on a partial tax liability for gains which took place earlier in the year which never accrued to his account. An IUL presents no such problem when late-year purchases are made.

10. The record-keeping requirements for owning mutual funds are significantly more complex. The keeping of excellent records (redemptions, purchases, dates, values, commissions, etc.) is often one's only defense in the event of an IRS audit. With an IUL, one's records are kept by the insurance company, copies of annual statements are mailed to the owner, and distributions (if any) are totaled and reported at year end.

11. Mutual funds are commonly part of a decedent's probated estate. Estate funds may be available to any and all creditors of the estate. In addition, they are subject to the delays and expenses of probate. The proceeds of the IUL policy, on the other hand, is always a non-probate distribution that passes outside of probate directly to one's named beneficiaries, and is therefore not subject to one's posthumous creditors, unwanted public disclosure, or similar delays and costs. Your heirs receive their insurance proceeds within weeks, not months or years after your passing.

12. Medicaid disqualification and lifetime income. An IUL can provide their owners with a stream of income for their entire lifetime, regardless of how long they live. Insurance is often classified so that it is not considered assets for Medicaid disqualification of nursing home costs. This is beneficial when organizing one's affairs, and converting assets to income prior to a nursing home confinement. Mutual funds cannot be converted in a similar manner, and are almost always considered countable Medicaid assets.

13. Chronic and terminal illness rider. All policies will allow an owner's easy access to cash from their policy, often waiving any surrender penalties when such individuals suffer a serious illness, need at-home care, or become confined to a nursing home. Mutual funds do not provide a similar waiver when contingent deferred sales charges still apply to a mutual fund account whose owner needs to sell some shares to fund the costs of such a stay.

14. Indexed universal life insurance provides death benefits to the beneficiaries of the IUL owners, and neither the owner nor the beneficiary can ever lose money due to a down market. Mutual funds provide no such guarantees or death benefits of any kind.

15. IULs allow the tax-free exchange of one policy for another. An indexed universal life insurance policy owner may exchange their policy for a completely different policy without triggering income taxes. A mutual fund owner cannot move funds from one mutual fund company to another without selling his shares at the former (thus triggering a taxable event), and repurchasing new shares at the latter, often subject to sales charges at both.

16. Mutual funds do not provide cost-free asset rebalancing whereas indexed universal life insurance does. This option is usually available among the major index choices (the S&P 500, NASDAQ, DJIA, Russell 2000, etc.), as well as a fixed interest option, at policy anniversaries. Rebalancing one's portfolio within a family of mutual funds always requires the sale and purchase of shares, often generating both taxes and commissions.

There are even more reasons why knowledgeable accountants prefer this remarkable savings vehicle, such as how the account value can be used to fund major purchases, college education, medical expenses, retirement income or any other cash need and continue to grow as if the money have never been used.