Indexed Universal Life Insurance

What is Indexed Universal Life Insurance?

Indexed universal life insurance (IUL) is a type of universal life insurance policy; it differs from a standard universal life contract in the mechanism used to credit interest to the cash value portion of the policy.

Structure of a Universal Life Policy

Unlike traditional whole life insurance, universal life policies specifically separate and identify the mortality, expense, and cash value elements of the contract. Dividing a policy into these three components allows the insurance company to build a higher degree of flexibility into the contract. Within certain limits, this flexibility allows the policy owner to modify the policy face amount[1] or premium, in response to changing needs and circumstances.

A monthly charge for both the mortality element and the expense element is deducted from a policy's account balance. The remainder of the premium is allocated to the cash value element where the funds earn interest. Complete disclosure of these internal charges against the cash value element is made to the policy owner in the form of an annual statement.

Universal life policies typically have several different provisions by which the accumulated cash value can be made available to a policy owner during life, without causing the policy to lapse. If a policy is terminated without the insured dying, there are various surrender options for the cash value.

Index Feature

In a standard universal life policy, interest is credited to the cash value portion of the policy by a method determined by the life insurance company, with most policies having a guaranteed minimum interest rate.

With an IUL policy, cash value is generally credited with a return that is the greater of the guaranteed minimum rate or the return based on a formula related to a specific market index, such as the Standard & Poor's 500 Index. If the underlying index rises sufficiently during a specific period, a greater return is credited to the cash value portion of the contract

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[1] Evidence of insurability may be required to increase a policy's death benefit.

for that period. If the underlying index does not rise sufficiently, or even declines, the lower minimum rate is generally credited. IUL policies thus provide a way to share in gains in the underlying index, while being sheltered from index declines.

How an Index Works

Although all IUL policies share the same objective, contracts can vary greatly in their specifics. A clear understanding of the index mechanism is helpful:

- **Participation rate:** Also known as the "index rate," the "participation rate" specifies the percentage increase in the index by which a contract will grow. For example "75% of the S&P 500's increase for the calendar year" means that if the S&P 500 index increases 10% for the year, the contract would be credited with 7.5%. In some cases, this rate is subject to change by the insurance company.

- **Cap rate:** The annual maximum percentage increase allowed. For example, if the chosen market index increases 15%, a contract with a 9.0% cap rate will limit the client's increase to 9.0%. Depending on the policy, there may be no cap rate, or the cap rate may be subject to change by the insurance company.

- **Measuring the index change:** There are three primary formulas used to measure the change in an index inside of an IUL:

    - **Daily averaging:** Typically done over a one-year term, this approach compares the index value at the beginning of the term, with the daily average index value over the entire term period.

    - **Monthly averaging:** Again, typically measured over a one-year period, the monthly averaging formula compares the index value at the beginning of the term, with the index value measured on the same day each month.

    - **Point-to-Point:** Compares the index value on the first day of the term (often one year) with the value on the last day of the term; any market changes in between are ignored.

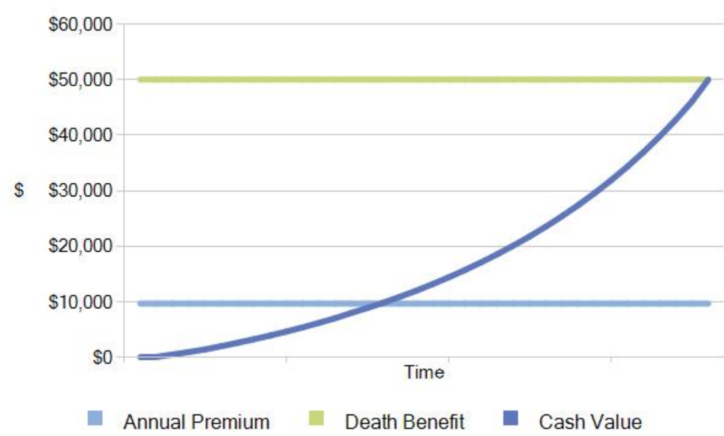
Policy Variations

There are two primary types of indexed universal life, based on the level of death benefits:

Type I indexed universal life:

Also known as option A, type I IUL policies pay a fixed, level death benefit, generally the face amount of the policy.

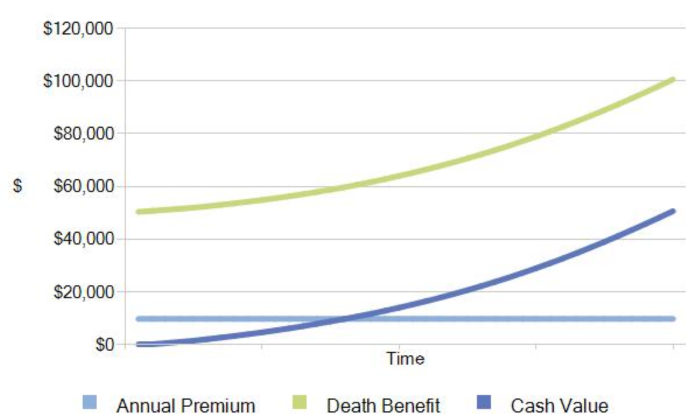
Example of Type I Indexed Universal Life



Type II indexed universal life:

Also known as option B, type II IUL policies generally pay the face amount of the policy plus the accumulated cash values. As the cash values grow, so does the potential death benefit.

Example of Type II Indexed Universal Life



Common Uses of Indexed Universal Life

IUL policies are useful for policy owners who expect their needs to change over time. Within certain guidelines, an IUL policy can be modified by changing the death benefit or premium payments. Some common uses are:

- **Family protection:** To provide the funds to support a surviving spouse and/or minor children, or to pay final bills such as medical or other estate expenses, as well as federal and state death taxes.
- **Business planning:** Because of its flexibility, indexed universal life insurance is often used for many different business purposes, such as insuring key employees, in split-dollar insurance arrangements, and funding nonqualified deferred compensation plans. Business continuation planning often involves IUL as a source of funds for buy-sell agreements.
- **Accumulation needs:** Some individuals will use the cash value feature of IUL as means of accumulating funds for specific purposes, such as funding college education, or as a supplemental source of retirement income.
- **Charitable gifts:** To provide funds for a gift to charity.

Modified Endowment Contracts (MECs)

A life insurance policy issued on or after June 21, 1988[1] may be classified as a modified endowment contract (MEC) if the cumulative premiums paid during the first seven years (7-pay test) at any time exceed the total of the net level premiums for the same period.

If a policy is classified as a MEC, all withdrawals (including loans) will be taxed as current income, until all of the policy earnings have been taxed. There is an additional 10% penalty tax if the owner is under age 59½ at the time of withdrawal, unless the payments are due to disability or are annuity type payments.

An IUL policy can avoid treatment as a MEC through a well-designed premium payment schedule. Caution must be exercised when changes in policy premium payments or death benefits are made, or when making partial withdrawals, to avoid having the policy inadvertently classified as a MEC.

Additional Policy Elements

Indexed universal life policies have a number of additional elements to consider:

- **Surrender charges:** Most IUL policies have substantial surrender charges, if a policy is terminated. These surrender charges are generally highest in the early years of a policy, and decline over a period of time, usually from seven to 15 years.

[1] Including a policy issued before that date, but later materially changed.

- **Policy loans:** IUL policies typically permit the policy owner to borrow at interest a portion of the accumulated cash value. The rate charged on the borrowed funds is often lower than current open market rates. A policy loan will reduce the death benefit payable if the insured dies before the loan is repaid; a policy loan will also reduce the cash surrender value if a policy is terminated. If the policy lapses or is surrendered with a loan outstanding, the loan will be treated as taxable income in the current year, to the extent of gain in the policy.

- **Partial withdrawals:** Most IUL policies allow a policy owner to withdraw a portion of the cash value, without terminating the policy. Such withdrawals reduce the amount of death benefit payable, and may be subject to current income tax, if the policy is classified as a MEC, or if the withdrawal exceeds cost basis for a non-MEC policy. Some contracts allow a policy owner to put the withdrawn funds back into the policy, but the insured may have to provide evidence of insurability to restore the original death benefit.

- **Surrender options:** If a policy owner surrenders a policy, there are generally three ways in which the accumulated cash value may be received, including: (1) taking the accumulated cash value, less any surrender charges; (2) receiving a reduced amount of paid-up insurance; or (3) taking paid-up term insurance in an amount equal to the original face amount of the policy.

Optional Policy Provisions

A number of optional policy provisions, commonly referred to as riders, can be added to a basic indexed universal life policy, generally through payment of an additional premium. Not all riders are available from all insurance companies.

- **Waiver of premium:** Suspends the monthly deduction for the mortality element of the policy, if the insured becomes disabled and is unable to work.

- **Accidental death:** Pays the beneficiaries double (in some situations triple) the face amount of the policy if the insured dies in an accident.

- **Spousal or family term insurance:** Allows a policy owner to purchase, at the time the IUL policy is issued, term insurance on a spouse or children.

- **Accelerated death benefits:** An accelerated death benefits provision allows for payment of part of a policy's death benefit while an insured is still alive. Such benefits are typically payable when the insured develops a medical condition expected to lead to death within a short period of time.

- **Guaranteed income benefit (GIB):** If a contract owner chooses to borrow from a policy's accumulated cash value, a GIB rider assures that there will always be funds available to borrow, no matter how long the owner lives.

- **Long-term care:** Helps pay for long-term care expenses, should the insured require such care.

Seek Professional Guidance

Indexed universal life insurance policies are primarily intended to meet long-term insurance needs. Because of this, and because of the complexity of IUL contracts, the guidance of appropriate tax, legal, and other financial professionals is highly recommended.