Universal Life Insurance

What Is Universal Life Insurance?

Universal life insurance contracts differ from traditional whole life policies by specifically separating and identifying the mortality, expense, and cash value parts of a policy. Dividing the policy into these three components allows the insurance company to build a higher degree of flexibility into the contract. This flexibility allows (within certain limits) the policy owner to modify the policy face amount 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. Unlike traditional whole life policies, complete disclosure of these internal charges against the cash value element is made to the policy owner in the form of an annual statement.

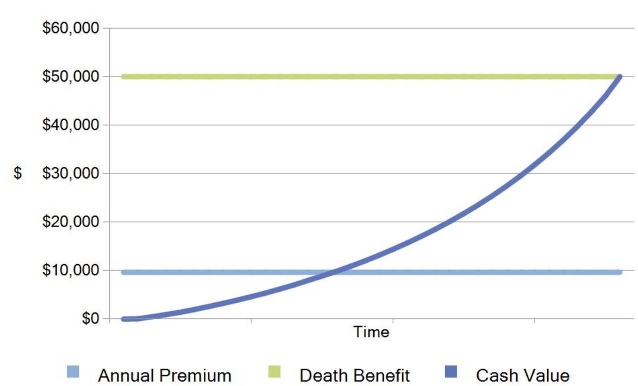
Many universal life policies have several different provisions by which the accumulated cash value can be made available to a policy owner during life, without causing the policy to lapse. If a policy is terminated without the insured dying, there are various surrender options for the cash value.

Policy Variations

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

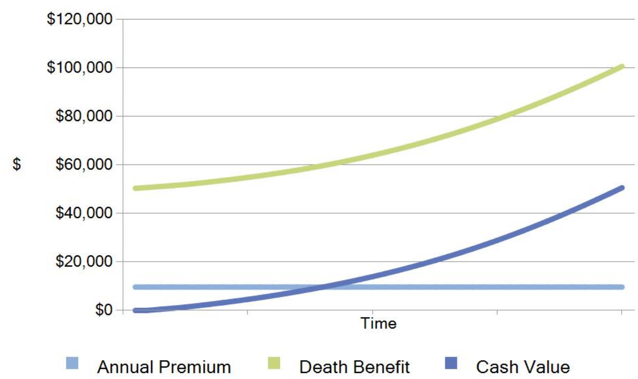
Type I universal life: Also known as option A, type I universal policies pay a fixed, level death benefit, generally the face amount of the policy.

Example of Type I Universal Life



Type II universal life: Also known as option B, type II universal 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 Universal Life



Common Uses of Universal Life

Universal life policies are useful for policy owners who expect their needs to change over time. Within certain guidelines, a universal life 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, 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 using universal life as a source of funds for buy-sell agreements.
- **Accumulation needs:** Some individuals will use the cash value feature of universal life 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.

A universal life 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

Universal life policies have a number of additional elements to consider:

- **Surrender charges:** Most universal life 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.
- **Policy loans:** Universal life 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 universal life 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

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

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 provisions, commonly referred to as riders, can be added to a basic universal life policy, generally through payment of an additional premium:

- **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 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.