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The *WRMarketplace* is created exclusively for AALU Members by the AALU staff and Greenberg Traurig, one of the nation's leading tax and wealth management law firms. The *WRMarketplace* provides deep insight into trends and events impacting the use of life insurance products, including key take-aways, for AALU members, clients and advisors.

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TOPIC: Getting Everyone on the Same Page - Life Insurance Basics for the Allied Advisor

MARKET TREND: The increased complexity and sophistication of life insurance products emphasize the importance of the advisor's role in explaining the fundamental differences between life insurance products to the client.

SYNOPSIS: Each client has a unique need and purpose for acquiring a life insurance product. Understanding the basic features of various term and permanent life insurance products, variations in such products, and available riders will aid the allied advisor in the selection of the product that best meets the client's planning needs.

TAKE AWAY: Allied advisors can add value by understanding the fundamentals of life insurance products and options to modify standard contracts.

PRIOR REPORTS: 15-15; 14-31.

Clients have different needs when it comes to life insurance. Some clients just need temporary insurance to cover expenses in the event of a death, such as to cover a short-term business need or to ensure lifestyle support. Others may view life insurance, in part, as a component of their investment portfolio, and others still may want to incorporate life insurance into an overall legacy plan to provide for liquidity that will help preserve a family business, farm, or other property. Correspondingly, life insurance contracts can be customized to provide a variety of terms and benefits. The selection of policy terms for a specific client will depend upon the purpose for which the insurance is acquired, the client's current and anticipated financial status, the length of time for which insurance is needed, and the client's risk tolerance.

POLICY TYPES & CONSIDERATIONS

Life insurance products generally fall into two main classes – term and permanent. Each class has its own set of benefits, limitations, and variations.

TERM INSURANCE

Term life insurance, the most common form, does not have an investment or cash value component, with coverage typically terminating at the end of the designated term. Because the policy isn't permanent and has no cash value build-up, premiums tend to be lower than other forms of life insurance. Most term policies are issued as single life policies, as opposed to second-to-die policies. Annual, level, and group term policies are all variations of term life insurance, and many clients likely will have some familiarity with one or more of these products.

Level-Term. A level-term policy provides a death benefit for a set period of time, which can be specified based on the policy owner's needs. The premiums and death benefit remain the same for the length of the contract. Level-term is frequently used for clients who need to cover expenses that may end after a specified number of years, such as expenses associated with the ownership of a company that the owner intends to sell.

Key Characteristics of Level-Term
• Provides coverage for a selected number of years (generally up to 30). Coverage often can continue after the initial term but at much higher premiums to account for the increased age of, and lack of updated underwriting information for, the insured.
• Longer terms generally equal higher premiums.
• Premiums are generally level for the policy term (although some policies may guarantee a level premium for only part of the term).
• Guaranteed death benefit as long as the premiums are paid.
• Frequently allow conversion of policy into permanent insurance without additional evidence of insurability and at the original classification, but require an increased premium to reflect insured's current age and conversion within a specified timeframe (e.g., within first 5-10 years of the contract or before insured reaches a designated age). This option can be helpful if the insured has a change in health and/or becomes uninsurable during the term.

Level-Term Variations: Term policy options include:

- Decreasing Term. Decreasing term policies have level premiums but annually decreasing death benefits. The policy terminates when the death benefit reaches zero.

- Return of Premium Rider. Return of premium policies provide for the return of all premiums paid on the policy if the insured survives the payment period. This additional protection will usually increase premium costs.

Group-Term. Many employers include group-term life insurance coverage as part of their employee benefits package.

Key Characteristics of Group-Term
• Coverage is provided regardless of the health of the employee.
• Premiums for the first $50,000 of death benefit are deductible by the employer and not treated as income to the employee. Premiums for excess death benefits are taxable to the employee as income to the extent of the equivalent term cost.[1]
• Coverage generally terminates when the employee leaves the company.[2]

➢ ***When to Consider:*** Term insurance generally is the lowest cost option for life insurance coverage and will be a good alternative for short-term or defined needs—possibly in certain family situations such as funding a post-divorce, fixed-term obligation, in a business setting to fund certain buy-sell obligations, or for key-man insurance on a key employee. As term policies do not accrue cash value and generally terminate after the designated term, they typically will not satisfy the objectives of clients with long-term family legacy, retirement, or business succession plans.

PERMANENT INSURANCE

Permanent life insurance products are designed for long-term retention and can provide a death benefit for the lifetime of the insured (or until the policy "matures" – e.g., when the insured reaches age 120), assuming required premiums are paid. Unlike term contracts, permanent policies generally include a cash value component that accumulates income and investment growth. Typically, the policy owner can access the cash value through withdrawals or borrowing against the policy. This policy growth and access to policy cash value (up to policy basis[3]) are not subject to current income, capital gains, or net investment income tax under appropriate and long-standing tax laws and principles.[4] Whole, universal and variable universal life insurance policies are all common types of permanent insurance.

Whole Life. Whole life policies provide more conservative clients with a guaranteed death benefit combined with a cash value that grows over time to equal the face value of the policy upon maturity.

Key Characteristics of Whole Life
• Premiums are fixed and level for the life of the insured. The policy owner can put additional funds into the policy that can grow on a tax-deferred basis.
• Provides a guaranteed death benefit (as long as the premiums are paid).
• The policy's cash value grows at a guaranteed rate (although usually lower than interest rates that are generally available). However, the assets that support the cash value are part of the insurance provider's general account and are subject to the claims of the provider's creditors.
• Whole life contracts may provide for the payment of dividends, although actual payment is not guaranteed. Dividends can be accumulated, used to reduce future premiums or, pursuant to a term rider, used to acquire additional insurance coverage. Dividends can also be paid to the policy owner up to the policy owner's basis in the policy without being subject to tax.
• Cash values are used to offset the death benefit upon the death of the insured.

Variations. The rigidity of ordinary whole life policies as to premiums has generated a number of variations to add flexibility.

- Paid-Up Policy. Paid-up policies are priced much the same as ordinary whole life policies but have a shorter period during which premiums are paid. Once all of the scheduled premiums are paid, payment of the death benefit is guaranteed without additional premium payments regardless of the performance of the insurance provider or the payment of dividends.

- Graded Premium Life Policies. These policies start with lower premium payments that gradually increase over time, such as 10 or 20 years. The ending premium payments are higher than if all the premiums had been equal from contract inception. Graded policies allow individuals who are currently unable to afford level premiums to acquire a whole life policy at initial lower premium rates.

- Modified Premium Life Policies. These policies are similar to graded life policies, but instead of graduated payments over time, the payments are level for a period of time with a single large increase in the premium at a specified point (such as 10 or 20 years after the date of issuance). Again, the premiums after the jump will be higher than if all of the premiums had been equal from inception of the contract.

- Single Premium Policy. Single premium policies require only one large premium to guarantee payment of the death benefit. However, such policies generally don't meet the standards set out in Internal Revenue Code ("**IRC**") § 7702A and are treated as modified endowment contracts ("**MECs**"). As discussed in *WRMarketplace No. 15-15*, different tax rules apply to MECs than to other life insurance contracts.

➢ ***When to Consider***: Whole life coverage may make sense for conservative clients wanting fixed, predictable premiums, guaranteed benefits, and cash value accumulation.

Universal Life. Universal life insurance, developed as an alternative to whole life policies, provides more flexibility as to the timing and level of premium payments. Generally, this type of policy also includes a guaranteed minimum rate of return on the cash value.

Key Characteristics of Universal Life
• Permanent coverage for the life of the insured or for a shorter period selected by the policy owner.
• Cash values and death benefit can be determined at time of issue based on the needs of the policy owner.
• Premiums are adjustable and can be paid at any time and in any amount, subject to specified limits. Payments above insurance costs are credited to cash value.
• Cash values grow based on interest rates set by the insurer on a monthly basis that are typically guaranteed not to drop below a specified rate. Universal life policies generally do not pay dividends.
• Cash values can be used for premium payments, to increase the death benefit, or for withdrawals (subject to income taxes if withdrawals exceed policy basis).
• The death benefit is guaranteed only so long as there is sufficient cash value to cover the monthly charges (subject to variations noted below). The policy must maintain sufficient cash value to keep the policy in force.

➢ ***When to Consider***: Universal life may make sense for clients that need permanent insurance but want flexibility in premiums and death benefits, as well as competitive cash value accumulation. The clients should have the discipline to pay premiums as needed and understand that premium requirements may increase depending on the payments made and the carrier's interest crediting rates.

Variations: Universal life policies are highly customizable, including as follows (note variable universal life is discussed below):

- Guaranteed Universal Life. Guaranteed universal life policies add a secondary guarantee that maintains a policy in force at a level death benefit for the guarantee period even if the cash value drops to zero; provided, however, that certain minimum premiums are paid for a set period. The guarantee typically comes at the cost of accessible cash value and premium paying flexibility. Premiums cannot be skipped and must be paid on-time, or the guarantee may be lost. The lack of a significant cash value also can limit the client's options to replace the coverage in the future. In addition, low interest rates and other market changes have impacted the availability and cost of these policies.

  - ***When to Consider***: These policies may be suited to clients concerned with providing liquidity at death and optimizing the death benefit relative to premiums paid, and for whom cash accrual, access to cash value and flexibility in premium payments is of minimal importance. However, these policies will be less well-suited to those who want the ability to adjust their plan in a few years to address any changes in family planning or tax laws.

- Indexed Universal Life. With indexed universal life policies, interest on cash values is linked to the percentage change of an index, such as the S&P 500, Dow Jones Industrial Average, or the NASDAQ 100. Rate increases are usually capped and rate decreases usually cannot go below a specified minimum. Guaranteed death benefits typically range from 10-30 years rather than for the lifetime of the insured.

  - ***When to Consider***: An indexed universal life policy may appeal to clients who do not want to invest directly in the market but are interested in tying rates of return to a market index and/or who are satisfied with giving up some potential "upside" in exchange for some "downside" protection and less volatility in returns.

- Increasing Death Benefit. Increasing death benefit universal life policies are structured to provide a death benefit equal to the face value of the policy plus the cash value. An increasing death benefit may help the benefit keep up with inflation.

  - ***When to Consider***: Clients who are concerned about the rising cost of living may be interested in this type of policy.

Variable Universal Life. Variable life, mostly seen today based on a universal life platform as variable universal life ("**VUL**"), expands the investment component of permanent life insurance policies and allows the policy owner to direct how the cash value will be allocated among a variety of investment options (subaccounts) provided by the insurance carrier, which are typically managed by third-party sub-advisors.[5] Thus, VUL policies combine the premium flexibility of a universal life policy with enhanced investment features.

The total policy cash value and/or death benefit will vary depending on the performance of the policy's subaccounts, increasing or decreasing based upon the success of the policy's investments. Some VUL products may include a rider/option for a guaranteed minimum death benefit for a specified period of time (typically at an additional premium cost).

Additional Characteristics of VUL
• Premiums in excess of the cost of insurance are deposited into a separate account that can be invested in subaccounts offered by the insurance provider.
• The insurance provider's creditors cannot reach the separate investment account.
• Premiums are adjustable and can be paid at any time and in any amount. Payments above the cost of insurance are credited to the cash value.
• Cash values can be used to make premium payments. However, if premium payments are not made and the stock market drops, a larger portion of the portfolio may need to be liquidated to pay the insurance charges.
• Permanent coverage can be provided for the life of the insured or for a shorter period selected by the policy owner.
• Cash values and death benefit can be adjusted based on the needs of the policy owner.
• The death benefit is guaranteed only so long as there is sufficient cash value to cover the monthly charges and to keep the policy in force.

*Variation – Private Placement Variable Universal Life ("**PPVUL**")*: PPVUL is a highly-customizable VUL product that allows the contract holder to negotiate with the insurer regarding policy costs, death benefit payment options, premium due dates and amounts, etc. to tailor the policy specifically to his or her planning goals.[6] As PPVUL investment options may include non-registered funds, however, PPVUL can be offered only to accredited investors or qualified purchasers as described by the Securities Act of 1933.[7]

➢ ***<u>When to Consider</u>***: VUL products may appeal to investment-oriented clients who can heavily fund the policy, have a long-term investment horizon, and prefer maximum control over the policy's investments and cash value growth over guaranteed benefits.

ADDITONAL POLICY OPTIONS - POLICY RIDERS

Riders can customize a policy to increase the policy's flexibility, modify certain provisions in the underlying contract, and address the client's specific needs. The terms and availability of riders vary among insurance providers. Some of the more common policy riders are listed below.

- A <u>term insurance rider</u> allows the policy owner to add more term insurance coverage to a permanent life insurance policy.

- A <u>disability waiver of premium rider</u> allows premium payments to be waived if the policy owner becomes disabled. The base policy will continue in force.

- A <u>disability income rider</u> provides the insured with supplementary income and a waiver of premiums if the insured becomes disabled.

- An <u>accidental death benefit rider</u> can provide for an increased death benefit (typically double the face value of the policy) in the event the insured's death is accidental.

- An <u>accelerated death benefit rider</u> allows a terminally ill policy owner to take advances against the death benefit under the policy while the insured is still living. If the advances meet the requirements of qualified viatical settlement payments, the advances may not be subject to tax.[8]

- A <u>long-term care rider</u> allows prepayment of a portion of the death benefit if the insured can no longer perform specified daily living activities and requires long term care.

- A <u>cost of living rider</u> provides for automatic death benefit increases to offset inflation.

- A <u>guaranteed purchase option rider</u> allows the policy owner to increase coverage on an annual basis without the insured undergoing additional underwriting. This type of rider may be useful in split dollar arrangements or to provide reduced benefits during the initial years of the policy if the three-year estate tax inclusion period applies.

- An <u>extended maturity rider</u> allows the policy owner to extend the date upon which the policy would otherwise mature or expire.

- A policy split rider provides for the division of a second-to-die policy into two separate single life policies upon a specified event, such as divorce or changes in tax laws.

- A return of premium rider provides for an additional death benefit equal to cumulative premiums costs. This rider may also be of benefit when entering into a split dollar arrangement or when the three-year estate tax inclusion period applies.

TAKE AWAY

Allied advisors can add value by understanding the fundamentals of life insurance products and options to modify standard contracts.

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NOTES

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[1] The equivalent term cost is determined under IRS Table I, Treas. Regs. § 1.79-3.

[2] Although some policies allow an employee to covert group term coverage into an individual insurance policy, the premiums generally will be higher to take into account the risk that only unhealthy employees will request such a conversion.

[3] Assuming the policy is not a modified endowment contract ("**MEC**"). See *WRMarketplace No. 15-15* for a detailed discussion of MECs and the tax rules applicable to those contracts. Note that if a policy owner decides to terminate the policy and receive the entire cash value, surrender charges may be incurred. These charges generally apply for the first 10 to 20 years of the policy, gradually decreasing over a specified period of time.

[4] See *WRMarketplace No. 14-31* for a discussion of the general federal tax rules applicable to life insurance contracts.

[5] Note that VUL products are subject to securities regulations, a full discussion of which is beyond the scope of this article.

[6] See *WRMarketplace No. 12-54* for a short discussion of some features of PPVUL.

[7] See 15 USC §80a-2(a)(51); 17 CFR § 230.501(a). An "accredited investor," in the context of a natural person, includes anyone who: (1) earned income that exceeded $200,000 (or $300,000 together with a spouse) in each of the prior two years, and reasonably expects the same for the current year, or (2) has a net worth over $1 million, either alone or together with a spouse (excluding the value of the person's primary residence). The financial thresholds for qualified purchasers are even higher.

[8] IRC § 101(g)(2)(B). The insured must have a life expectancy of no more than two years to qualify for the tax-free treatment.