Ordinary Level Premium Whole Life Insurance

# Introduction

Whole life insurance, as the name implies, is a contract designed to provide protection over the insured’s entire lifetime. There are many types of whole life policies, but the oldest and still the most common type of whole life policy is ordinary level premium whole life insurance, or simply ordinary life. This form of insurance is also known as “straight life,” “traditional whole life,” or “continuous premium whole life.” If the term “whole life” is used alone, it is generally accepted that the reference is to ordinary level premium whole life as opposed to any other type of lifelong policy.

This type of contract features level or fixed periodic premiums computed on the assumption that the policyowner can retain the policy for the life of the insured. The death benefit remains level throughout the lifetime of the contract. Insurers invented the level premium concept to make the whole life contract affordable for as long as the policyowner decided to keep it.

As an outgrowth and natural byproduct of the fixed and level premium, the whole life contract develops cash values. These values result from the reserve the insurer needs to accumulate in the early years of the policy’s life so that they will have sufficient money (together with interest earned on the reserve) in later years to pay the promised death benefit while keeping premiums level. Absent this reserve, the level premium would be insufficient to pay the increasing mortality costs as the insured ages. The policy contains a fixed and guaranteed schedule of the cash values that the policyowner may borrow for any reason (such as an emergency or opportunity) at any time or take upon surrendering the contract.

The policyowner agrees to pay a fixed or level premium at regular intervals for the rest of the insured’s life (generally only up to age 100, if the insured lives that long, or in some cases, to age 95). In return, the insurance company agrees to pay a fixed death benefit when the insured dies if the policyowner has continued to pay the premiums. Policyowners who discontinue paying premiums and terminate their policies are entitled to the scheduled cash surrender value.

# When is the Use of This Device Indicated?

In general, some type of life insurance is indicated when a person needs or wants to provide an immediate estate upon his or her death. This need or desire typically stems from one or more of the following reasons.

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1. To provide income for dependent family members until they become self-supporting after the head of household dies.

2. To liquidate consumer or business debts or mortgages, or to create a fund that would enable the surviving family members to do so when the head of household dies.

3. To provide large amounts of cash at death for children’s college expenses or other capital needs.

4. To provide cash for federal estate and state inheritance taxes, funeral expenses, and administration costs.

5. To provide funds for the continuation of a business through a “buy-sell” agreement.

6. To indemnify a business for the loss of a key employee.

7. To help recruit, retain, retire, or reward one or more key employees through a salary continuation plan and to finance the company’s obligations under that plan to the dependents of a deceased key employee.

8. To fund bequests of capital to children, grandchildren, or others without the erosion often caused by probate costs, inheritance taxes, income taxes, federal estate taxes, transfer fees, or the generation-skipping transfer tax.

9. To fund charitable bequests.

10. To preserve confidentiality of financial affairs. Life insurance proceeds payable to someone other than the deceased’s estate are not part of the probate estate and are not a matter of public record. It is not unusual for a beneficiary to be a lover, illegitimate child, or to have some other relationship to the insured that the insured may not want to publicly acknowledge. Likewise, the insured may not want the amount payable to the beneficiary to become a matter of public record.

11. To assure nearly instant access to cash for surviving dependents. Insurers generally pay life insurance proceeds to beneficiaries within days of the claim. There is no delay, as might be the case with other types of assets, because of the intervention of state or other governmental bodies due to settlement of tax issues, or because of claims by the decedent’s creditors.

12. To direct family assets to family members in a way that minimizes state, local, and federal taxes.

13. Level premium whole life, in particular, is the preferred type of policy when the need is long-term and there is a desire to maintain a relatively fixed annual premium cost. For many families, it is the most “affordable” form of long-term coverage on the principal breadwinners.

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14. Level premium whole life may satisfy various business related life insurance needs (e.g., financing vehicles for buy-sell agreements, key person insurance and nonqualified deferred compensation arrangements). It is especially suitable if the objective is also to receive tax sheltered returns and the company has accumulated earnings problems. The cash buildup in life insurance policies held for legitimate business purposes is not counted towards the accumulated earnings limitation.

15. Level premium whole life insurance is often the preferred type of insurance for split dollar arrangements. (See Chapter 41 for a further discussion.)

16. Level premium whole life is a tax-sheltered way to finance post-retirement health insurance for a selected group of executives or key employees by using life insurance policies on their lives. Cash values are available to the corporation to help meet future cash needs for health insurance premium payments for retirees. When the employee dies, the corporation receives the death proceeds free from federal income tax (except for some potential alternative minimum tax liability). The corporation is reimbursed for part or all of its costs for the post-retirement health insurance. Corporate Owned Life Insurance (COLI) offers certain advantages over other methods for recovering post-retirement health insurance liabilities.

# Tax Implications

General Tax Rules

Death benefits are usually free of any federal income tax. In general, death benefits paid under these policies are subject to the same income, estate, gift, and generation-skipping transfer taxation rules as all other types of life insurance policies. See Chapters 22 through 30 for a complete discussion of the taxation of life insurance.

Taxation of Living Proceeds

Section 72 of the Internal Revenue Code governs the taxation of living proceeds from life insurance policies. Living proceeds are generally any amounts received during the insured’s lifetime. For tax purposes, payments are separated into three classes: (1) annuity payments; (2) payments of interest only; and (3) amounts not received as an annuity.

*Annuity payments* – Annuities include all periodic payments received from the contract in a systematic liquidation of the cash value. This includes both life contingent annuities and fixed term or fixed amount annuities. The rules of IRC Section 72 determine what portion of each payment is treated as a tax-free recovery of investment in the contract

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and what portion is treated as taxable income or gain. To oversimplify, the rules essentially pro rate the recovery of investment in the contract over the expected payout period. Therefore, each payment is treated partially as recovery of investment and partially as taxable interest until the entire investment in the contract has been recovered. Any further payments are treated entirely as taxable income. (See Chapter 8 for a more in depth discussion of the taxation of annuities.)

*Payments of interest only* – Payments consisting of interest only (i.e., they are not part of the systematic liquidation of a principal sum) are not annuity payments and are not taxed under the annuity rules. In general, if living benefits are held by the insurer under an agreement to pay interest, the interest payments are taxable in full when distributed or simply credited to the account.

*Amounts not received as an annuity* – In general, all living proceeds except for interest and annuity settlements are taxed under the “cost recovery rule.” Included in this category are policy dividends, lump-sum cash settlements of cash surrender values, cash withdrawals, and amounts received on partial surrender. These amounts are included in gross income only to the extent they exceed the investment in the contract (as reduced by any prior excludable distributions received from the contract). In other words, nonannuity distributions during life are first treated as a return of the policyowner’s investment in the contract (generally premiums paid less dividends received), and then as taxable interest or gain.

The exceptions to this rule are generally unlikely to arise with level premium policies. The first exception is with respect to policies that initially fail the seven-pay test under the Modified Endowment Contract (MEC) rules. Because level premium policies are designed to have premiums payable for the life of the insured, they are not likely to fail the seven-pay test. The second exception is with respect to policies that originally satisfied the tests to avoid MEC treatment, but that as a result of certain changes in the benefits of the contract, subsequently fail the tests. Once again, the types of changes that would jeopardize favorable MEC status are unlikely to arise with ordinary level premium whole life policies. Problems are more likely to arise with limited pay policies and universal life policies. If any life insurance contract is treated as a MEC, cash distributions are generally taxed under the interest-first rule. Under this rule, distributions are first attributed to interest or gain in the contract and are fully taxable. Only when the interest or gain is exhausted are distributions treated as a nontaxable recovery of investment in the contract.

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*Loan proceeds* – Policy loans under non-MEC life insurance policies are not treated as distributions. If a policy loan is still outstanding when a policy is surrendered, the borrowed amount becomes taxable at the time of surrender to the extent the cash value exceeds the policyowner’s investment in the contract. Loans are essentially treated as if the borrowed amount was actually received at the time of surrender and used to pay off the loan.

# How Do I Select the Best of Its Type?

Selecting the best cash value life insurance policy is a difficult task involving a number of complicated concepts and analyses. (See Chapter 4, “How to Determine the Right Policy” for a further discussion.) However, because the level of dividend payments on participating ordinary level premium life insurance is a critical element of the overall cost of the protection, one primary area of focus should be how the company determines the dividends it pays.

How to Evaluate the Dividends Paid on Par Policies

1. Compare the current rate credited to policy cash values and the length of the guarantees. All else being equal, policies with higher current rates and longer guarantee periods will be better than those with lower current rates and shorter guarantees.

2. Check to see how the company will determine the rate credited to policy cash values after the guarantee period. Policies that determine the rate based on a specific money rate or bond index leave the company with little room to manipulate the amount credited in an adverse way.

3. Look at the current mortality and expense factors and compare them with the guaranteed maximum mortality and expense factors. The mortality factors currently used should be competitive. If the difference between the current mortality rates and the maximum rates is small, the company has little room to use higher mortality charges as a means of reducing the effective rate credited to cash values.

4. Look for a bailout provision that reduces or eliminates surrender charges if investment performance does not meet reasonable guidelines.

5. Check the policy loan provision to see if the company uses an “offset” provision to credit borrowed amounts with a lower rate than nonborrowed amounts. If the insured anticipates borrowing from the policy, a company that does not use the offset method is preferable. If borrowing is not anticipated, a company that uses the offset method may be more desirable because the company, in theory, should be able to credit higher interest to policies without borrowing than they otherwise would be able to credit without the offset provision.

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6. Check the financial soundness of the company using the criteria in Chapter 3, “How to Determine the Right Company.” In the past, some insurance companies attempted to increase their portfolio yield by investing a substantial portion of their assets in relatively high yield but also high risk “junk” bonds. As a result of adverse market conditions and increased defaults on these bonds, some of these companies experienced serious financial stress and reduced portfolio yields.