Indexed Universal Life

# Introduction

Indexed Universal Life (IUL) is a pseudo-hybrid of regular (or fixed) universal life (UL) and variable universal life (VUL). Like regular UL, it is a flexible premium, current assumption, adjustable death benefit type of cash value permanent life insurance with a guaranteed minimum interest crediting rate. Like VUL, the amount the insurer credits to the cash accumulation account is tied to an equity index such as the S&P 500 or the Nasdaq 100. Most IUL policies allow policyowners to allocate their cash value amounts between a fixed account and one or more equity index accounts. Thus, insurers have designed IUL to give policyowners the opportunity to participate in the gains when market indexes turn up while being protected from market downturns. Although the amount credited to the cash value account is based upon one or more equity indexes, the cash value account is NOT directly invested in the stock market. This is why IUL is called a pseudo-hybrid in that it somewhat mimics, but does not actually duplicate, the cash value account methods of VUL policies.

# When Is the Use of This Device Indicated?

Potential policyowners may consider IUL for any life insurance need. Initially, the insurer and policyowner may configure an IUL policy’s death benefit and target premium level to resemble virtually any type of life insurance policy from annually renewable term insurance to single premium whole life. However, both because of policy costs and because equity-type investments generally are more suitable for middle- to longer-term investment horizons, IUL generally is best suited for longer-term coverage needs. For short-term needs (less than five to ten years), a nonrenewable term policy generally will be more cost effective.

1. Some sort of UL, including IUL for those people looking for some of the upside potential of equities in their cash values while being protected on the downside, is indicated whenever policyowners desire the ultimate in flexibility in life insurance. Policyowners whose circumstances change can later reconfigure the policy by changing their premium payments and/or the death benefit. IUL

2. UL has been extremely popular in the family market and IUL is now not far behind in popularity. For example, young parents with growing families and modest incomes can acquire IUL policies that they initially configure with low premiums and high death benefits resembling traditional renewable term policies. As the parents’ incomes grow, they can increase premiums to build tax-sheltered cash within the policy. At later times when they need cash, such as to pay for a child’s education,

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they can reduce premium payments or stop them altogether and use the cash values to help pay the school expenses. After a time, they can increase premiums once again to build cash values. Similarly, if the amount of death protection that they need changes, they may decrease or increase the death benefit. However, increases in death benefits usually will require evidence of insurability.

3. IUL also has become extremely popular in the business market where flexibility often is essential and the higher investment earning potential is very attractive. IUL is beginning to surpass UL as the preferred vehicle in all sorts of business applications including split dollar plans, funding for nonqualified deferred compensation plans, key person insurance, funding vehicles for buy-sell agreements, and even in insured qualified retirement plans.

# Tax Implications

General Tax Rules

The income tax rules for IUL policies are virtually identical to the tax rules for UL policies which are essentially the same as the tax rules for other types of life insurance policies. Beneficiaries receive death benefits that usually are free of any federal, state, and local income tax. IUL policies also are subject to the same estate, gift, and generation-skipping transfer taxation rules as all other types of life insurance policies.

Also, the income tax rules for living benefits paid from IUL policies are the same as living benefits paid from other types of life insurance policies. Generally, the cost-recovery rule governs the taxation of these living benefits. The cost-recovery rule, which is sometimes called the First-In First-Out (FIFO) rule, treats amounts received as nontaxable recovery of the policyowner’s investment in the contract. Only after policyowners fully recover their investment in the contract are additional amounts that they receive treated as taxable interest or gain in the policy. Included in this category of living benefits are policy dividends, lump-sum cash settlements of cash surrender values, cash withdrawals, and amounts received on partial surrender. Policyowners include these amounts 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, the income tax rules generally treat nonannuity distributions during life, first, as a return of the policyowner’s investment in the contract and then–only after the owner has recovered the entire investment in the contract–as taxable interest or gain.

Being that the equity-indexed interest crediting method is the distinguishing feature of IUL, most policyowners are looking to enhanced cash value accumulations as

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compared with cash-value accumulations in other types of policies that use conventional interest-crediting methods. Consequently, the exceptions to the cost-recovery tax rule for payments of living benefits under IUL policies and the tax risks associated with IUL policies being classified as modified endowment contracts are especially important tax considerations.

Chapter 18 “Universal Life”, covers exceptions to the cost recovery tax rule for living benefits and the risks and tax consequences of a policy being treated as a MEC for tax purposes for those readers who want to view an in-depth discussion of these topics.

# 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. (See Chapter 4 “How to Determine the Right Policy”, for a further discussion of the basic principles.) However, because the amount insurers credit to cash values on IUL policies is a critical element of the overall cost of the protection, one primary area of focus should be how the company determines the amount it credits to cash values.

The amount insurers credit to cash values each year depends on four factors:

1. The expenses insurers charge against the policy

2. The mortality charges insurers assess against the policy

3. The net investment yield earned by the insurers on their portfolio of investments

4. The method insurers use to allocate interest to various blocks of policies

The cash value at the end of any given year is equal to the cash value from the end of the prior year plus premiums (or less withdrawals) paid during the year less expense and mortality charges and plus interest credited. The annual report usually will explicitly show the expense and mortality charges and the interest credits each year.

Expense Charges

As described previously, two elements usually comprise the expense charge; a fixed annual fee plus a percentage of premiums paid. The company may or may not reveal these fees in its original policy illustration. However, even if it does, the company usually makes no guarantee that they will not change the expense charges. Actual expense charges may increase or decrease in future years.

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Mortality Charges

Every IUL policy explicitly states the maximum mortality rates it will charge for all ages and guarantees that mortality rates will not exceed those maximums. Many companies now use the 2001 Commissioner’s Standard Mortality (CSO) table as the basis for their contractually guaranteed maximum rates, but some companies still use the older 1980 CSO mortality table for their new policies. In addition, all policies issued before 2002 used the 1980 CSO mortality table or, possibly, the 1958 CSO mortality table. All three tables are very conservative—that is, they assume mortality rates that are considerably higher than what is actually expected—but the 1980 CSO table and, even more so, the 1958 CSO table are considerably more conservative than the 2001 CSO table. Virtually every company currently charges less than the stated maximums, but those using the more conservative 1980 or 1958 CSO tables have more room to increase mortality charges in future years if their mortality experience is poor.

Although annual statements explicitly show actual mortality charges, many policy illustrations do not. In fact, some illustrations assume very low or no mortality charges, which tend to show projected cash values that are overstated relative to what policyowners can actually expect. Other illustrations include mortality charges based on rates the company is assessing currently, but they also may assume that mortality experience will improve in future years. If the mortality improvements do not materialize as anticipated, actual cash values are unlikely to match the projected cash values.

Net Investment Yield on Investment Portfolio

Over the long run, insurance companies cannot credit more interest to policy cash values than they earn on their general investment portfolios. To assess a company’s long-run interest crediting ability, one should evaluate the insurer’s current portfolio and its investment philosophy.

As a general rule, insurance companies invest their portfolios predominantly in long-term corporate and government bonds and mortgages. However, there are differences in the proportions invested in each type of asset and in the quality, duration, yields, and risk. In the past, overly aggressive investments in high yield and high risk junk bonds and developmental mortgage loans pushed some companies to insolvency. Therefore, one’s objective should be to select companies with investment portfolios and investment philosophies that show a reasonable and acceptable combination of risk and return. What is reasonable and acceptable, of course, depends on the level of risk and the certainty of return desired by the policyowner.

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Companies offering IUL policies typically do not actually invest directly in the stocks in the equity indexes they use in their equity-index interest crediting formulas. Rather, they invest the majority of policyowners’ net premiums in the conventional assortment of long-term corporate and government bonds and mortgages. They take the remainder of the net premiums and buy options on the equity indexes (or on futures contracts on the equity indexes) they use in their interest-crediting formulas.

Interest-Crediting Methods

Just as with UL–when the policyowner pays IUL premiums–a portion pays for the pure insurance cost based on the age and rating of the insured. Another portion pays for various fees and expenses, including amounts for any riders or special provisions attached to the policy; the rest goes into the cash value. What happens next-in general terms-is that, unlike whole life and regular UL, IUL uses an equity-index interest crediting formula allowing the interest credited to the cash value account to fluctuate in relation to one or more stock market indexes of financial performance such as the Standard & Poor’s 500 or the Nasdaq 100.

*Equity indexes*. The equity indexes that insurers use for their interest crediting formulas are *price* indexes, not *total return* indexes. Price indexes do not include dividends, interest, or other investment income investors would earn if they purchased a mutual fund tracking one of the major indexes, such as the S&P 500. To get index returns comparable to a mutual fund investing in the S&P 500 in an IUL policy, the equity index would have to be the S&P 550 Total Return Index, not the S&P 500 Index. Therefore, the rates of return on the indexes used in IUL policies generally will be lower than the rates of return policyowners would earn if they actually bought the stocks in the index (or an efficient mutual fund or ETF tracking the index).

There is no reason, in theory, that companies could not use other indexes of financial assets, such as various bond indexes, REIT indexes, commodity indexes, or precious-metals indexes, etc., in their interest crediting formulas. However, the authors are unaware of any companies currently offering IUL policies using any of these other types of non-equity indexes.

Three other factors, in addition to the performance of one or more equity indexes, enter into the interest crediting formula: *a guaranteed minimum crediting rate*, *a cap rate*, and *a participation rate*. IUL policies usually allow insurers to change these key parameters annually, at the discretion of the insurance company.

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*Interest crediting strategies*. Insurers determine the rate of return to enter into their interest crediting formulas in their IUL policies using a variety of crediting strategies. The most common are the *annual* point-to-point (or *ratchet*) method, the *monthly* point-to-point method, and the *monthly averaging* method.

* *Point-to-point crediting methods*. Both of the point-to-point crediting strategies begin the crediting cycle with a marker at the beginning of the contract, and track the movement of the underlying stock index(es) to the next point. For *annual point-to-point*, the insurer tracks the index for one year; for *monthly point-to-point*, one month. The difference from the first point to the second point represents the percent of interest that enters the policy’s interest crediting formula.
* *Monthly averaging method*. Under monthly averaging, insurers track monthly index changes and then average them over 12 months. This annualized average rate then enters the annual interest crediting rate formula to determine the amounts insurers will credit to cash values at the end of the year.

For example, using the annual strategy, if the index rose 5 percent over the course of a year, 5 percent would serve as a starting point in the interest crediting formula determining the amount the insurer will credit to policy cash values. Under the monthly strategy, if the index rose 1 percent in a month, the interest crediting formula would use 1 percent in the calculation of the amount of interest to add to cash values.

*Problems with averaging strategies*. The problem with the interest crediting strategies is that they are usually hard for policyowners to understand. Additionally, one never knows in advance which crediting strategy will produce the best outcome for a policyowner over the course of the next 12 months. Also, many policies make the policyowners commit to a crediting strategy for relatively long-term periods, such as five-year segments. This means that if a particular crediting strategy does not perform as the policyowners had hoped, the policyowners cannot move the money that they already have allocated to that crediting strategy until the end of the five-year segment.

*Guaranteed minimum crediting rate*. The guaranteed minimum crediting rate is the minimum rate insurers will apply to cash value balances if the rate determined by their interest crediting formula is less than the guaranteed minimum rate. For most policies, this minimum rate is 0 percent, but some policies have minimum rates of 1% percent to 2 percent, annual (or about 1/12th of this rate when the interest crediting formula uses the monthly point-to-point method). This guaranteed minimum rate prevents the interest crediting formula from computing a rate that would reduce principal value in the cash value account.

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*Cap rate*. The cap rate is an upper limit on the equity index rate that the interest crediting rate formula will use to determine the amount the insurer will credit to cash values. For instance if the cap is 8 percent, insurers will ignore any gains in the indexes over 8 percent when they compute the amounts to credit to cash values.

*Participation rate*. Insurance companies also control interest crediting through participation rates. For example, if a policy earns 8 percent in any given year, uses an annual point-to-point crediting method, and has a 100 percent participation rate, the interest crediting formula will use the full 8 percent rate in determining amounts the insurer credits to policy cash values. However, if the participation rate is only 60 percent, the interest used in the interest crediting formula will be only 4.8 percent (8 percent x 60 percent). If the participation rate is 140 percent, interest crediting formula would use an 11.2 percent rate to determine the amounts credited to cash values. Participation rates typically vary from between 60 percent and 150 percent. Also, insurers can adjust the participation rates either up or down, making future cash value growth predictions difficult. A low participation rate on a policy is an obvious sign of a reduced interest crediting potential.

*Equity-index interest crediting formula*. The amount that insurers credit to IUL policy cash values depends on four factors:

* the **G**ain rate on the selected equity index for the relevant period: **G%**
* the **C**ap rate, if applicable: **C%**
* the guaranteed **M**inimum rate, if applicable: **M%**
* the **P**articipation rate: **P%**

The cash value crediting rate (**CV%**) is determined using the following formula:

**CV%** = Max(**M%,** Min(**G%,** **C%**)) x **P%**

***Example***: Assume **G%** = **10%**, **C%** = **7%**, **M%** = **0%**, and **P%** = **80%**

**CV%** = Max(**0%,** Min(**10%**, **7%**)) x **80%**

**CV% =** Max**(0%, 7%**) x **80%**

**CV%** = **7%** x **80% = 5.6%**

The insurer would credit cash values with 5.6% interest.