Variable and Variable Universal Life

# Introduction

Variable Life

Variable Life (VL) insurance combines traditional whole life insurance with mutual fund type investments. Basically, it is a whole life policy where the policyowner may direct the investment of cash values among a variety of different investments.

VL has a guaranteed minimum face amount and a level premium like traditional whole life insurance, but it differs in three respects:

1. The policyowner’s funds are placed in separate accounts that are distinct and separate from the company’s general investment fund.

Insurers place policyowner premiums, less an expense or sales load and a mortality charge, into a separate investment account. The policyowner may choose to invest premiums and cash values among several mutual-fund type alternatives, typically including, at a minimum, stock funds, bond funds, and money market funds. Many companies that market VL offer a broader array of investment options such as foreign stock funds, bond funds, GNMA funds, real estate funds, zero-coupon bond funds, and specialized funds such as small capitalization stock funds, market-index funds, and funds that focus on specific sectors of the economy or industries (medical, high tech, gold, leisure, utilities, etc.). Some companies offer a managed fund option where the company’s investment manager assumes the responsibility for allocating investments among the various alternative funds. Some VL policies also offer a guaranteed interest option similar to the declared interest rate on universal life policies. Policyowners typically may switch or rebalance their investments among the funds one or more times per year.

2. The insurer does not guaranteed a minimum cash value.

The cash value at any point in time is based on the market value of the assets in the separate account. VL policyowners bear *all* the investment risk associated with the policy.

3. The death benefit is variable.

The face value may increase or decrease but not below the guaranteed minimum (based on a formula that relates the investment performance of the separate account to the face value). Companies use two methods to establish the relationship

Variable and Variable Universal Life

between the investment performance and the face amount. Under what is called the corridor percentage approach, the insurer periodically adjusts the death benefit so that it is at least equal to a specified percentage of the cash value, as required by current tax law.[[1]](#endnote-1) The mandated corridor percentage is 250 percent until the insured reaches age 40 or so and then gradually declines to 100 percent by age 95, typically.

*Example.* Assume the cash value is $40,000 at the beginning of the period and $50,000 at the end of the period. The insured is 60 years old. The initial death benefit is $52,000 and the corridor percentage factor is 130 percent. At the end of the period, the death benefit will be $65,000, or 130 percent of $50,000.

Under what is called the net single premium approach insurers adjust the death benefit so that it matches the amount of insurance that the policyowner could purchase with a single premium equal to the cash value, assuming guaranteed mortality rates and a low rate of return, typically 4 percent.

*Example.* Assume the net single premium factor in the example above is 0.65374. That is, it takes $0.65374 to buy $1 of insurance for life. At the end of the period, the death benefit will be $50,000/0.65374, or $76,483.

Although both methods are equally valid, most policyowners find the corridor percentage method easier to understand.

VL has most of the usual features of traditional level premium life insurance including guaranteed maximum mortality charges, nonforfeiture values, a policy loan provision, a reinstatement period, and settlement options.

Also, VL policies may be participating or nonparticipating. In contrast to traditional par policies, dividends paid on par VL policies depend only on possible mortality and expense savings and include no element of excess investment earnings. Excess investment earnings, less an asset management fee, are reflected directly in the value of the separate account.

Similar to other traditional forms of insurance, policyowners may add various options or riders including, particularly, waiver of premium, guaranteed purchase or insurability, and accidental death benefits, as well as others.(See Chapter 6; “Special Policy Provisions and Riders,” for further discussion of options and riders.)

Variable and Variable Universal Life

Insurers that market VL often offer a number of initial premium payment plans including single premium, limited pay (for a specified number of years or until a specified age), and lifetime pay plans.

Variable Universal Life

Variable Universal Life (VUL), which also is called flexible premium variable life or universal life II, is a combination of universal life and variable life. VUL offers policyowners the flexibility of universal life (UL) with respect to premium payments and death benefits. Specifically, VUL owners can:

1. determine the timing and amount of premium payments (within limits);

2. skip a premium payment if the cash value is sufficient to cover the mortality and expense charges;

3. adjust the amount of the death benefit in response to inflation or changing needs (subject, generally, to policy minimums and, with respect to increases, evidence of insurability requirements);

4. withdraw money without creating a policy loan and without an interest charge if there is sufficient cash value to cover mortality and expense charges; and

5. choose between two death benefit options similar to options A (or I) and B (or II) for UL policies. Under option A, the death benefit remains level, similar to a traditional policy. Under option B, the death benefit is equal to a level pure insurance amount plus the cash value.

The death benefit of a VUL policy is not variable in the same sense as the death benefit of a VL policy. Under option B, the death benefit will vary directly, not indirectly by formula, with changes in the cash value. Under option A, the death benefit is level. However, the death benefit of VUL policies is flexible or adjustable, within limits and subject to insurability requirements, at the discretion of the policyowner.

VUL policyowners receive periodic reports that explicitly show mortality and expense charges and changes in the investment value of their accounts.

Because variable life products are considered securities, the insurer (or insurer’s agent) must give the prospective purchasers a prospectus. The prospectus contains the identity and nature of the insurer’s business, the use to which the insurer will put the premiums, financial information on the insurer, and the investment characteristics of the product, as well as the policy’s expenses, fees, loads, and policyowner rights. In addition, the agent must be properly licensed to sell security products.

Variable and Variable Universal Life

# When Is the Use of This Devise Indicated?

Variable life products are most suitable for those individuals who want control over their cash values and need or desire increasing life insurance protection. They should have a basic understanding of investments and believe they are capable of making good investment decisions. They must be willing to bear the entire risk of their investments because the insurance company does not guarantee the cash values of VL products. If the policyowner expects the need for death protection to grow, VL death benefit levels will increase with favorable investment experience on the underlying assets. However, policyowners have no assurance that this growth will be consistent. Policyowners face a risk that the market value of the underlying assets and, therefore, the death benefit level, will be depressed when the insured dies.

VUL offers greater certainty of death benefit levels than VL as long as policyowners continue to pay premiums at the level necessary to maintain the death benefit. Under option B, death benefit levels are more certain to increase. VUL also permits the policyowner to increase the face amount of coverage with evidence of insurability.

Given the risks and uncertainties associated with both cash values and death benefit levels, some people may find variable life products an attractive supplement to an existing life insurance plan that assures a minimum required base level of coverage. Generally, VL and VUL are less suitable as the means of providing the minimum basic level of coverage.

VL and, more particularly, VUL are especially suitable for many business insurance needs where flexibility and growth of cash values and death benefits are necessary or attractive features. Businesses can use these policies to provide potentially higher tax-deferred cash value accumulations in nonqualified deferred compensation plans than traditional policies or UL. With successful investment of cash values, the death benefit levels of variable products are more likely than those of traditional products to keep pace with increases in the values of closely-held business interests when a variable product funds a buy-sell agreement. Businesses may also find VL and VUL equally attractive for key person insurance and other business applications or in insured pension plans.

Variable and Variable Universal Life

# Tax Implications

General Tax Rules

VL products that do not violate the modified endowment contract rules are taxed in the same manner as other types of life insurance policies. Death benefits usually are paid free of any federal income tax. Variable life insurance policies are subject to the same income, estate, gift, and generation-skipping transfer taxation rules as all other types of life insurance policies.

The tax rules for living benefits from VL products also are the same as for living benefits from other types of life insurance policies. The cost-recovery rules of Internal Revenue Code Section 72 govern the taxation of annuity-type distributions. These rules state that policyowners recover their investments in their contracts (generally, total premiums paid less prior nontaxable distributions) ratably over their expected payout periods.

Interest paid on or credited to living benefits held by the insurer under an agreement to pay interest is taxable immediately in full. The cost-recovery rule generally applies for the taxation of all other types of living benefits. The cost-recovery rule, which is sometimes called the First-In First-Out (FIFO) rule, treats amounts received first as a nontaxable recovery of the policyowner’s investment in the contract. Only after policyowners fully recovers their investment are additional amounts they receive treated as taxable interest or gain in their policies. 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 such amounts in gross income only to the extent such amounts exceed the investment in the contract (as reduced by any prior excludable distributions owners receive from their contracts). In other words, nonannuity distributions during life generally are first treated as a return of the policyowner’s investment in the contract and then as taxable interest or gain.

Exception to the Cost-recovery Rule

The general cost-recovery rule may not apply for withdrawals within the first 15 years after the policy issue date that are coupled with reductions in death benefits. Because insurers generally reduce death benefits in an amount equal to any withdrawal of cash values, policyowner withdrawals frequently may trigger a tax on all or part of these withdrawals to the extent of gain in the policy.

Variable and Variable Universal Life

The rules tax such withdrawals in whole or in part as ordinary income to the extent that they are forced out of the policy as a result of the reduction in the death benefits. The taxable amount depends on when the owner makes the withdrawal:

* Within first five years ­– If the withdrawal takes place within the first five years after policy issue, a very stringent and complex set of tests applies.[[2]](#endnote-2) Potentially, a larger portion, or perhaps all, of any withdrawal within the first five years will be taxable if there is gain in the policy.
* Fifth to fifteenth years – For withdrawals between the end of the fifth year and the end of the fifteenth year from the issue date, a mathematical test applies. Essentially, the rules tax the policyowner on an income-first basis to the extent the cash value before the withdrawal exceeds the maximum allowable cash value under the cash value corridor test for the reduced death benefit after the withdrawal.[[3]](#endnote-3) Frequently, in these cases only a portion or even no part of the withdrawal will be taxable.

Changing from option B (increasing death benefit) or from option C (return of premium) to option A (level death benefit) will trigger a test to see whether any amount must be forced out of the policy. In general, option B and option C contracts allow for greater cash accumulations within the policy than option A contracts. Consequently, if a policy with option B or option C has close to the maximum permitted cash value under that option, a switch to option A generally will trigger a taxable distribution. (See Chapter 22 through 29 for a complete discussion of the taxation of life insurance.)

Caveat: Potential Taxation under the MEC Rules

The flexibility inherent in VUL policies with respect to changes in premiums and death benefits raises the possibility that the policy could become a modified endowment contract (MEC).[[4]](#endnote-4) The penalty for classification as a MEC relates to distributions. If a policy is classified as a MEC, distributions under the contract are taxed under the interest-first rule rather than the cost-recovery rule. In addition, to the extent taxable, these distributions are subject to a 10 percent penalty if they occur before the policyowner reaches age 59½, dies, or becomes disabled. So MEC categorization of a VUL contract means both faster taxation of investment gains and a possible penalty tax for early receipt of that growth.

Distributions under the contract include nonannuity living benefits (as described above), policy loans, loans secured by the policy, loans used to pay premiums, and dividends taken in cash. Distributions under the contract do *not* include dividends used to pay

Variable and Variable Universal Life

premiums, dividends used to purchase paid-up additions, dividends used to purchase one year term insurance, or the surrender of paid-up additions to pay premiums.

Changes in premiums or death benefits may inadvertently cause a VUL policy to run afoul of the MEC rules in basically three ways:

1. An increase in premium payments during the first seven contract years may push the cumulative premiums above the amount permitted under the seven-pay test.[[5]](#endnote-5)

2. A reduction in the death benefit during the first seven contract years triggers a recomputation of the seven-pay test. The seven-pay test is applied retroactively as of the original issue date as if the policy had been issued at the reduced death benefit.

3. A material increase of the death benefit at any time triggers a new seven-pay test which is applied prospectively as of the date of the material change.

When issued, most VUL policy illustrations show the maximum amount (the seven-pay guideline annual premium limit) that the policyowner may pay within the first seven years without having the policy classified as a MEC. If policyowners inadvertently exceed that maximum, they can avoid MEC status if insurers return excess premiums to the policyowners with interest within 60 days after the end of the contract year in which the excess occurs. The interest will be subject to taxation.[[6]](#endnote-6)

In general, a reduction in death benefit within the first seven contract years caused by and equal in amount to a withdrawal is less likely to cause the policy to fail the recomputed seven-pay test than a death benefit reduction without a withdrawal. However, a policy will fail the seven-pay test if, in any year, the cumulative premiums paid to that year exceed the sum of the seven-pay guideline annual premiums to that year.

*Example.* Assume the guideline annual premium is $10,000 based on the original death benefit. The policyowner pays $9,000 each year for the first 6 years. In year seven, the policyowner withdraws $36,000, with a corresponding decrease in the death benefit. The recomputed guideline premium is $8,000. The policy now fails the seven-pay test and is a MEC because cumulative premiums paid in just the first year, $9,000, (and through year 6 as well) exceed the sum of the recomputed guideline annual premiums of $8,000.

Any reduction in death benefits attributable to the nonpayment of premiums due under the contract will not trigger a recomputation of the seven-pay test if the benefits are reinstated within 90 days after being reduced.[[7]](#endnote-7)

Variable and Variable Universal Life

A change from option B (face amount plus cash value) or option C (face amount plus return of premium) to option A (face amount) appears to be a decrease that triggers the look-back rule and a retroactive reapplication of the seven-pay test. In general, one would not expect the switch in options to result in a lower seven-pay limit unless the insurer also reduced the face amount of insurance to less than the face amount at the time of issue. Therefore, switching from options B or C to option A should not, in general, cause the policy to be reclassified as a MEC.

The term material change is not defined in the statute. However, the statute states that it “includes any increase in future benefits under the contract,”[[8]](#endnote-8) but *not* increases attributable to dividends (for paid-up additions), increases in the policy’s cash surrender value attributable to the investment performance of assets underlying the policy, increases necessary to maintain the corridor between the death benefit and the cash surrender value required by the definition of life insurance,[[9]](#endnote-9) or cost of living adjustments.

Clearly, increases in death benefits attributable to cash value increases from favorable investment performance will not trigger testing under the material change rules. Whether changing from option A to options B or C constitutes a material change in death benefit is unclear. Other increases in death benefits requiring evidence of insurability will be considered material changes that invoke a new seven-pay test. See Chapter 22, “Modified Endowment Policies,” for more information.

Taxation of Capital Gains on the Underlying Assets

Capital appreciation on the assets underlying a VL or VUL policy loses its character as capital gain. To the extent taxable, withdrawals or surrenders are taxed at ordinary income tax rates. The maximum federal tax table rate on ordinary income is (in 2012) 35 percent, but effective tax rates can be even higher due to the phaseout of personal exemptions and itemized deductions. In contrast, capital appreciation recognized on the sale of similar mutual fund investments is treated as capital gains. The maximum federal tax rate on long-term capital gains is (in 2012) 15 percent. In addition, taxpayers may use capital gains to offset capital losses.

Taxation of Transfers between Investment Funds

Transfers or switches between one fund and another offered by an insurer under a VL or VUL policy are tax-free. In contrast, similar switches between funds in a family of mutual funds are treated as taxable sales and repurchases. However, in recent years, legislation has been proposed to tax transfers or switches between one fund and

Variable and Variable Universal Life

another under a VL or VUL life policy or annuity in a manner similar to switches between funds in a mutual fund family. Although these proposals have never survived legislative debate, the possibility clearly exists that such proposals could be enacted in the future.

# Where and How Do I Get It?

Many life insurance companies, including some of the largest, are marketing variable life products. Most of the major stock brokerage firms also market variable life products. Agents who sell variable life products must be properly licensed to sell security products.

# How Do I Select the Best of Its Type?

The key factors in choosing the best VL or VUL policy are the policy loadings and expenses, the suitability and variety of the investment options, and the relative performance of the company’s alternative investment accounts. The prospectus must list and explain the various loadings and charges. However, because there is a great deal of variability in these loadings and expenses, it is difficult to determine which policy provides the lowest effective package of fees over the long term. The best procedure is to ask for policy illustrations with equal face amount and rate of return assumptions and to compare future cash value accumulations. This is not without its problems, however, because the companies may have different current mortality assumptions and may or may not be assuming future improvements in their mortality experience.

Some companies offer a broader array of investment options than others. All else being equal, potential policyowners should prefer the company with the broadest array of offerings.

Potential policyowners can evaluate relative performance of various investment accounts in much the same manner as one would evaluate mutual funds. The prospectus provides historical information about total returns, expense ratios, and turnover rates. In addition, it must describe the investment management fees. One should compare similar types of funds offered by each company to control for risk. For example, only compare long-term bond funds with long-term bond funds or diversified stock funds with diversified stock funds. A sophisticated analysis would compare risk-adjusted returns, but that can be a daunting task for less knowledgeable investors.[[10]](#endnote-10)

All else being equal, look for companies offering funds with the lowest management fees, the lowest turnover rates, the lowest investment expense ratios, and the highest total returns (or best risk-adjusted return).

Variable and Variable Universal Life

How to Navigate Through a Variable Life Ledger Statement

The principal source of information regarding a new policy is the policy illustration or ledger. Figure 1 shows an annotated policy illustration with the following commentary.[[11]](#endnote-11)

**Figure 1**

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
| LEDGER STATEMENT FOR VARIABLE LIFE | | | | | | | | |
| $100,000 Variable Whole Life Plan **1**  For Age 45 Male **2**  Annual Premium $2,394 **3**  4  Dividends Used to Purchase Paid-up Additions | | | | | | | | |
| **5** | **6** | **7** | **8** | **9** | **10** | **11** | **12** | **13** |
| **End of Year** | **Annual Premium** | **Premiums Accumulated at 5%** | **Death Benefit\* Assumed Investment Returns** | | | **Cash Value\* Assumed Investment Returns** | | |
| **0%** | **6%** | **12%** | **0%** | **6%** | **12%** |
| 1 | $2,394 | $ 2,514 | $101,367 | $101,391 | $101,532 | $ 1,103 | $ 1,154 | $ 1,205 |
| 2 | 2,394 | 5,153 | 102,707 | 103,880 | 103,510 | 3,145 | 3,372 | 3,606 |
| 3 | 2,394 | 7,924 | 104,024 | 104,471 | 105,962 | 5,164 | 5,700 | 6,268 |
| 4 | 2,394 | 10,834 | 105,304 | 106,157 | 108,904 | 7,156 | 8,137 | 9,216 |
| 5 | 2,394 | 13,890 | 106,549 | 197,941 | 112,382 | 9,201 | 10,776 | 12,572 |
| 6 | 2,394 | 17,098 | 107,749 | 109,818 | 116,420 | 11,214 | 13,536 | 16,286 |
| 7 | 2,394 | 20,467 | 108,910 | 111,797 | 121,060 | 13,190 | 16,422 | 20,395 |
| 8 | 2,394 | 24,004 | 110,023 | 113,872 | 126,335 | 15,126 | 19,434 | 24,935 |
| 9 | 2,394 | 27,717 | 111,088 | 116,046 | 132,287 | 17,013 | 22,573 | 29,949 |
| 10 | 2,394 | 31,617 | 112,107 | 118,327 | 138,968 | 18,853 | 25,845 | 35,485 |
| 11 | 2,394 | 35,712 | 113,068 | 120,705 | 146,416 | 20,634 | 29,248 | 41,591 |
| 12 | 2,394 | 40,011 | 113,961 | 123,176 | 154,678 | 22,351 | 32,782 | 48,320 |
| 13 | 2,394 | 44,525 | 114,772 | 125,729 | 163,796 | 23,999 | 36,451 | 55,733 |
| 14 | 2,394 | 49,265 | 115,490 | 128,357 | 173,818 | 25,570 | 40,255 | 63,896 |

Variable and Variable Universal Life

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
| 15 | 2,394 | 54,242 | 116,104 | 131,052 | 184,800 | 27,055 | 44,192 | 72,874 |
| 16 | 2,394 | 59,468 | 116,604 | 133,808 | 196,801 | 28,444 | 48,262 | 82,743 |
| 17 | 2,394 | 64,955 | 116,984 | 136,624 | 209,890 | 39,727 | 52,460 | 93,580 |
| 18 | 2,394 | 70,716 | 117,238 | 139,502 | 224,146 | 30,891 | 56,784 | 105,469 |
| 19 | 2,394 | 76,766 | 117,359 | 142,443 | 239,654 | 31,923 | 61,230 | 118,496 |
| 20 | 2,394 | 83,118 | 117,334 | 145,442 | 256,496 | 32,806 | 65,790 | 132,756 |

**Figure 1**

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
| LEDGER STATEMENT FOR VARIABLE LIFE | | | | | | | | |
| $100,000 Variable Whole Life Plan **1**  For Age 45 Male **2**  Annual Premium $2,394 **3**  4  Dividends Used to Purchase Paid-up Additions | | | | | | | | |
| **5** | **6** | **7** | **8** | **9** | **10** | **11** | **12** | **13** |
| **End of Year** | **Annual Premium** | **Premiums Accumulated at 5%** | **Death Benefit\* Assumed Investment Returns** | | | **Cash Value\* Assumed Investment Returns** | | |
| **0%** | **6%** | **12%** | **0%** | **6%** | **12%** |
| 60@ | 2,394 | 54,242 | 116,104 | 131,052 | 184,800 | 27,055 | 44,192 | 72,874 |
| 65@ | 2,394 | 83,118 | 117,334 | 145,442 | 256,496 | 32,806 | 65,790 | 132,756 |
| 75@ | 2,394 | 167,007 | 112,535 | 180,166 | 527,026 | 34,997 | 118,565 | 74,646 |
| **14** | Insurance Premiums | | | Annual | Mo. ISA |  |  |  |
|  |  | | | 2,394.00 | 211.10 |  |  |  |
|  | Subject to Underwriting Limits **15** | | |  |  |  |  |  |
|  | Select **16** |  |  |  |  |  |  |  |
| **17** | \*Dividends based on current scaleð1988 issue. Not an estimate or guarantee of future results. Hypothetical investment results are illustrations only and should not be deemed representative of past or future investment results. Results illustrated assume no loans. 8% loan provision. The illustration must be preceded or accompanied by a current prospectus. | | | | | | | |

Variable and Variable Universal Life

1. Initial death benefit is $100,000; plan of life insurance is variable life.

2. Gender and issue age–male, age 45.

3. $2,394 is the annual premium.

4. Projected dividends are determined by mortality and expense factors used to purchase variable benefit paid-up life insurance. The projected dividends are small (e.g., at the beginning of the second year - $490; at the beginning of the fifth year - $592; at the beginning of the tenth year - $652; and at the beginning of the twentieth year - $453).

5. End-of-year ledger statement. This means the initial death benefit of $100,000 is assumed to be paid at the beginning of the year. Subsequent death benefit, depending upon the interest assumption (e.g., 0 percent, 6 percent, and 12 percent), is assumed to be paid at the end of the year. Cash values (the assumed values of the separate investment account–0 percent, 6 percent, and 12 percent) are calculated as of the end of the year.

6. Out-of-pocket cash payment is $2,394 each year, paid on an annual basis.

7. 5 percent interest assumption column. The value of $2,394 compounded at 5 percent if not used to purchase life insurance.

8. Death benefit increase because of the projected dividends purchasing additional paid-up life insurance. In the absence of dividends, the death benefit would not increase because the separate investment account must produce a rate of return in excess of 4 percent in order for the death benefit to increase.

9. Death benefit increases due to the projected dividends purchasing additional paid-up life insurance and the 6 percent interest assumption.

10. Death benefit increases due to projected dividends purchasing additional paid-up life insurance and 12 percent interest assumption.

11. This column has a value even at 0 percent interest assumption because not all of the premiums paid were required to meet the insurance company’s expenses.

12. The projected value of the separate investment account (cash value) based on a net investment return (after expenses and deductions) of 6 percent.

13. The projected value of the separate investment account (cash value) based on a net investment return (after expenses and deductions) of 12 percent.

14. Annual premium for $100,000 variable life is $2,394. The monthly premium by automatic deduction from checking account is $211.10.

15. The underwriting requirements (medical, social, and economic) of the insurance company must be met, in order for the insurance to be issued.

16. Insurability status – e.g., nonsmoker or smoker, or rated (extra charge because of being a higher risk for medical or occupational reasons). Select for this company means nonsmoker, nonrated. It is the company’s best insurability classification.

Variable and Variable Universal Life

17. Statement about dividends, assumed investment returns (e.g., 6 percent and 12 percent) and loan interest of 8 percent. In addition, there is a statement pertaining to the prospectus which clearly indicates that variable life is considered a security and as such must be registered with the Securities and Exchange Commission (SEC).

What Ledger Statements Do Not Tell

You should be told either verbally or in writing the following additional information:

* The separate investment account, which is analogous to the reserve (cash value) of traditional whole life, graded premium life, interest sensitive, and universal life, is made up of four divisions: (1) stock; (2) bond; (3) money market; and (4) master portfolio. The master portion typically consists of common stock, other equity securities, bonds, and money market instruments. Inquire about what percentage of your net premium can go into each. In addition, find out how often you can change from one to the other.
* Note whether the various expenses and deductions are contractually guaranteed not to increase. For this company, variable life policy charges to the policy are: sales loads, policy fees, annual administration charges, state premium tax, and risk charge. Charges to the separate investment account are: cost of insurance (mortality charges), mortality and risk expense, and management fees and expenses. Ask for a total disclosure of each.
* The rate of return expressed in terms of compound interest should be given either on the ledger statement or by the life insurance agent. Ideally, it should be provided for each year.
* The rate of return upon death for this policy for sequential years is as follows:

|  |  |
| --- | --- |
| Year | Rate of return |
| 1 | 4,141.10% |
| 5 | 86.94 |
| 10 | 30.81 |
| 20 | 14.25 |

* The above rates are based on a 12% interest assumption death benefit.

Variable and Variable Universal Life

* The rate of return upon death can be used when comparing various variable life policies among respected companies. (It can also be used for any life insurance policy.) Consider the following example:

|  |  |
| --- | --- |
| Rate of return upon  death in year 20 | Cost per $1,000  of life insurance per  year for 20 years |
| 14.25% | $ 9.34 |
| 14.23 | 9.36 |
| 13.25 | 10.59 |
| 13.00 | 10.93 |

* How were these numbers determined? $1,000 is the future value (death benefit) to be paid, 20 years is the time. Interest is known (14.25 percent, 14.23 percent, 13.25 percent, 13 percent). You then solve for payment – how much must be spent each year to accumulate $1,000 in 20 years at the various interest rates?
* Once the rate of return upon death is known, then it can be determined what would have to be earned before taxes in other financial services products such as mutual funds, certificates of deposit, real estate, or commodities to duplicate the tax-exempt rate of return provided by life insurance. (For this purpose, it is assumed that the death benefit is considered life insurance proceeds and as such not subject to federal or state income taxes.) The before-tax rate of return is determined by dividing the life insurance rate of return by the marginal tax bracket subtracted from 100 percent (for 15 percent, the factor is 0.85; for 25 percent, 0.75; for 28 percent, 0.72; for 33 percent, 0.67; and for 35 percent, 0.65). The result is shown in Figure 19.2.

**Figure 2**

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| Year | 15%  taxpayer | 25%  taxpayer | 28%  taxpayer | 33%  taxpayer | 35%  taxpayer |
| 1 | 4,871.88% | 5,521.47% | 5,751.53% | 6,180.75% | 6,370.92% |
| 5 | 102.28 | 115.92 | 120.75 | 129.76 | 133.75 |
| 10 | 36.25 | 41.08 | 42.79 | 45.99 | 47.40 |
| 20 | 16.76 | 19.00 | 19.79 | 21.27 | 21.92 |

Variable and Variable Universal Life

* The rate of return upon surrender should also be provided. When the rate of return upon surrender is positive, it means that taxes are due. Taxes are due on the difference between the cash surrender value and the premiums paid. The result before taxes is as follows:

|  |  |
| --- | --- |
| Year | Rate of return |
| 1 | -49.67% |
| 5 | 1.64 |
| 10 | 7.05 |
| 20 | 8.95 |

* The above rates of return are based on a 12% interest assumption separate investment account performance. The rate of return upon surrender even before taxes never equals the separate investment account investment performance of 12 percent.
* The Premiums Accumulated at 5 percent column on the ledger statement replaces the Interest Adjusted Index. This is what your money would be worth at 5 percent net after taxes if not used to purchase life insurance. In order to net 5 percent after taxes, the before-tax rates of return in the following tax brackets are:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| 15%  taxpayer | 25%  taxpayer | 28%  taxpayer | 33%  taxpayer | 35%  taxpayer |
| 5.88% | 6.67% | 6.94% | 7.46% | 7.69% |

* The ledger statement should be the official ledger statement produced by the computer service of the life insurance company. It should be bug-free.

1. IRC Sec. 7702(d). [↑](#endnote-ref-1)
2. IRC Secs. 7702(f)(7)(B), 7702(f)(7)(C). [↑](#endnote-ref-2)
3. IRC Secs. 7702(f)(7)(B), 7702(f)(7)(D). The cash value corridor test is discussed in Chapter 24. [↑](#endnote-ref-3)
4. In cases where there are extreme reductions in the death benefit or very large premium payments, it is even possible for a policy to fail the tests for life insurance under IRC Section 7702 with much more disastrous tax consequences. See the discussion of the definition of life insurance in Chapter 24. [↑](#endnote-ref-4)
5. IRC Sec. 7702A(a)(1)(B). Classification as a MEC occurs in the year when seven-pay test is first violated and for each year thereafter. See Chapter 22 for a more complete discussion of the seven-pay test. [↑](#endnote-ref-5)
6. IRC Sec. 7702A(e)(1). [↑](#endnote-ref-6)
7. IRC Sec. 7702A(c)(2)(B). [↑](#endnote-ref-7)
8. IRC Sec. 7702A(c)(3). [↑](#endnote-ref-8)
9. IRC Sec. 7702. See Chapter 24. [↑](#endnote-ref-9)
10. An excellent book on this subject is *Modern Mutual Fund Families & Variable Life: Tools for Investment Growth and Tax Benefits,* by Carl E. Anderson and James B. Ross (Homewood, IL: Dow Jones-Irwin, 1988). [↑](#endnote-ref-10)
11. This illustration is adapted from William D. Brownlie and Jeffery L. Seglin’s treatise, *The Life Insurance Buyer’s Guide* (new York, NY: McGraw-Hill Publishing Company, 1989). [↑](#endnote-ref-11)