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Quiz

Types of Whole Life Insurance

Let's take a look at some of the types of whole life policies. The first three types of whole life policies discussed are the most basic forms of whole life insurance. They are straight whole life, limited-pay whole life, and single premium whole life, and are classified based on how the policyowner pays the premium.

A. Straight Life

Straight life, also known as continuous premium whole life (or traditionally, ordinary level-premium whole life), charges a level annual premium for the lifetime of the insured and provides a level, guaranteed death benefit. As any whole life policy, straight life insurance builds cash value. All other factors being equal, straight life policies have the lowest annual premium among whole life policies.

Ordinary level-premium whole life is the oldest form of life insurance protection. 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 the other types of lifelong policies. Premium payments are level and payable for the whole of life or to age 100.

The policy builds up cash value and, if it is a participating contract, also pays dividends. These are values that result from the reserve that the insurer needs to accumulate in the early years of the policy's life so that there will be sufficient money in later years to pay the promised death benefit while keeping premiums level. Ordinary level-premium whole life insurance provides a specified death benefit that is paid to the beneficiary when the insured dies. Policyowners who discontinue paying premiums and terminate their policies are entitled to the scheduled cash surrender value, which will be detailed in the nonforfeiture benefits section of the contract.

There are different tax rules for death benefits and living proceeds. Death benefits for all forms of life insurance are usually paid free of any federal income tax. Living proceeds are generally any amounts received during the policyowner's lifetime. A cash value policy typically can generate two types of living benefits that are not present in a term life insurance policy: a policy loan, or a distribution of all cash values upon policy surrender.

Policy loans are generally not taxable because the amount of loan allowed will never exceed the policyowner's income tax cost basis in the policy. The income tax cost basis in a life insurance policy is the total of all premiums paid, plus dividends not paid out in cash, less any outstanding loans; basically, the total of all premiums paid. If a policyowner surrenders a cash value, there will not be income tax due unless the amount of cash values paid to the policyowner exceeds the income tax cost basis of the policy.

B. Limited Pay Whole Life

A variation on straight life is **limited-pay whole life.** The only difference between straight life and limited-pay life is that, as the name implies, a limited-pay policy specifies a set number of years during which the policyowner must pay premium. After the premium is paid up, the policy remains in force for the insured's lifetime. Two common examples are a 10-pay life, in which the policy is paid up after 10 years of premium payments, and limited-pay to age 65 (or LP65), in which the policy premium is calculated to be paid up by the insured's age 65. Again, the policy then stays in force for the remainder of the insured's life.

Limited-pay policies usually have higher premiums than straight life policies because the premium payment period is condensed. Because the premiums are higher, limited-pay policies accumulate cash value more quickly and continue to build cash value after the premium payment period ends.

LP65 policies are becoming more common as people decide they want life insurance coverage during retirement, but don't want to pay premiums during retirement.

C. Single Premium Whole Life

Another type of policy that relates to the way the premium is paid is called **single premium whole life.** These policies use a one-time, lump-sum premium payment to provide a level death benefit to the maturity of the policy. Single premium policies generate immediate cash value because of the size of the lump-sum premium payment. This type of policy often is purchased with the death benefit of a previous policy or with an employment severance package. An interest rate is applied annually to the cash value.

The way these policies differ from other traditional whole life policies is that they are subject to a surrender charge if the policy is surrendered within a certain time period. Generally, the surrender period is 7 to 10 years on a diminishing basis. In other words, the charge will be higher if the policy is surrendered in year 3 than if it is surrendered in year 7.

D. Current-Assumption Whole Life

Current-assumption whole life could be called a hybrid of traditional cash-value whole life insurance and universal life insurance. It is similar to a traditional whole life policy in that, at the time of issue, the premium and the death benefit levels are fixed. On the other side of the policy is the universal life characteristics, with separate interests and charges channeled to the accumulation account.

Current-assumption whole life is utilized when an individual wants the fixed-premium, "forced-savings" feature of traditional whole life and the potential for better investment results than those guaranteed in traditional polices. Current-assumption whole life insurance policies have a minimum guaranteed cash value accumulation, but the policyowner bears the risk that the investment performance and mortality experience of the company could be less favorable than originally assumed.

The tax rules on current-assumption whole life insurance policies are similar to other types of life insurance policies. These policies are subject to the same income, estate, gift, and generation-skipping transfer taxation rules as all other types of life insurance policies. Death benefits generally are paid free of federal income tax.

Living benefits from current-assumption whole life insurance policies also are taxed in the same manner as living benefits from any other life insurance policies. Annuity-type distributions are taxed by calculating an exclusion ratio as provided by Internal Revenue Code Section 72, which states that the policyowner's investment in the contract is recovered ratably over the expected payout period.

Other types of living benefits such as partial surrenders or policy loans generally are taxed under the "cost-recovery rule." Only after the policyowner's investment is fully recovered are additional amounts treated as taxable interest or gain in the policy.

An important exception to the general cost-recovery rule is for withdrawals within the first 15 years after the policy issue date that are coupled with reductions in death benefits. Because death benefits are generally reduced in an amount equal to any withdrawal of cash values, these withdrawals generally will be fully or partially taxable to the extent of gain in the policy.

Most current-assumption policies have low or no initial charges or front-end fees. Rather, most or the entire first year's premium is added to the cash accumulation account and begins to earn interest immediately. The commission and other startup costs of issuing any new policy are considerably large, and these have to be recovered.

The surrender charge can be determined explicitly by looking at the policy illustration or ledger statement, which shows both cash value figure and net cash value figures for each of the policy years. The **cash value** is the amount on which interest credits are based. The **net cash value** is the amount that the insurance company would pay if the policy were surrendered. This difference is the **surrender charge.** There are also other charges, such as ongoing administrative expenses and state premium tax expenses.

E. Interest-Sensitive Whole Life Insurance

Interest-sensitive whole life is also known as adjustable life or current interest whole life. This policy allows a policyowner to adjust the face amount, premium, and length of protection without having to complete a new application or request issuance of a new policy. In later years, a policyowner may adjust the premium, face amount, or period of death protection to meet current needs.

With interest-sensitive whole life insurance, the temporary protection could be changed to permanent coverage, and the death benefit or the face amount could be reduced because of the policyowner's age and premium commitment. The premium for a whole life policy is determined based on certain assumptions regarding company investment, mortality, and administrative experience. The premium for interest sensitive whole life is determined the same way. However, where other premiums are fixed for the life of the policy, interest-sensitive premiums are fixed for only one year.

Interest-sensitive policies contain guarantees that the interest paid on the cash value will not fall below a certain rate, and the mortality charge will not rise above a specified amount. Some policies tie the price of the premium to the interest rates being earned. Thus, if the interest rate is high, the price of the premium will go down. If the interest rate is low, the premium will go up. In such policies, there will be a maximum premium than can be charged.

Interest-sensitive whole life policies may have fixed or flexible premiums and death benefits. These products generally do not pay dividends explicitly but may pay implicit dividends. Instead of receiving an actual dividend payment:

- The policy may be credited with excess interest;

- Lower mortality charges may be deducted from the cash value; and
- A sales load may be waived after a certain period of time.

F. Modified Premium Whole Life

Modified premium whole life (MPWL) is a life insurance policy featuring a lower initial premium that remains level for the policy's first years (usually 5 years), then increases to its ultimate premium in year 6, and remains at that level for life. It is best suited for established individuals seeking a large amount of insurance and moderate cash value accumulation at a reduced premium.

MPWL policies provide permanent life insurance protection and lower premiums during the first 5 years. They also accumulate tax-deferred, guaranteed cash value. The loan provision allows the policyowner to borrow from the guaranteed cash value. The policyowner is eligible for dividends if the policy is a participating policy and when declared by the company. Then the death benefit may increase annually with paid-up additions purchased from dividends. In most instances, this death benefit is free from federal income tax.

In business planning, an MPWL policy can provide for the smooth transition of a business upon the death of a partner when combined with a buy/sell contract. It can also provide an employee benefit. A business can use it as a split dollar arrangement by covering an employee with an insurance policy with premiums paid by the employer. The employer owns the policy, but the employee can name the beneficiary.

Upon the death of the employee, the employer receives proceeds equal to the cash value of the policy, while the beneficiary receives the remaining proceeds. An MPWL policy offers deferred compensation to employers so that they have the opportunity to provide benefits to employees at a later date (upon retirement, for example). It can also offer salary continuation, giving employees supplemental retirement and death benefits. A buy/sell agreement will be funded through a life insurance plan.

G. Second-to-Die Whole Life Insurance

Second-to-die whole life insurance insures two people, typically a husband and wife, and provides a death benefit to the beneficiary upon the death of the second insured. These plans are designed to provide cash to cover estate taxes or business liability considerations that have to be paid after both people have died. Second-to-die insurance contracts are usually variations of OL, GPL, and universal life. One important advantage of a second-to-die contract is that its dual coverage costs less than purchasing two separate policies. The policy is designed to provide funds to cover estate taxes due when the second spouse dies. These plans can be based on either whole life or universal life. The heirs of the estate are usually beneficiaries of the second to die policy because they can use the tax-free death benefit to pay estate taxes and other estate settlement costs.

H. Fixed Premium Whole Life

A **Fixed Premium Whole Life** plan is designed to provide solutions to a variety of life insurance needs: a moderate amount of coverage for small children, a basic plan for young adults to build upon, and small amounts of insurance on members of associations who do not have an employer/employee relationship. An important use of this plan is to provide payment of final medical care, hospital, legal, and funeral expenses, which is an often overlooked need with older adults. A fixed premium whole life policy is a permanent plan that provides a level amount of protection and level

premiums until age 100. The plan includes a built-in cash value that is guaranteed to increase at 4.5% for the life of the plan, which adds an important living benefit to the coverage. The benefits of the fixed premium whole life policy may add the guaranteed insurability benefit to ensure the purchase of additional insurance at ages 25, 28, 31, 37, and 40, or when specific events occur, such as college graduation, marriage, home purchase, or the birth/adoption of a child.

I. Advantages and Disadvantages of Whole Life Insurance

Whole life insurance has many advantages and disadvantages, depending on the situation of the insured individual. Because these situations vary to such a great degree, an insurance agent must look closely at these factors, as disadvantages to some people may actually be advantages for others, and vice versa.

1. Advantages

Whole life policies provide the following **advantages** to the policyowners:

- A guaranteed ceiling on mortality and expense charges and a guaranteed floor on interest credited to cash value;
- Safety due to close regulatory supervision of company solvency;
- An opportunity for investment management because life insurance companies provide skilled personnel and broadly diversified investment portfolios;
- Cash value interest or earnings accumulate tax-free or tax-deferred, depending on whether gains are distributed at death or during lifetime;
- Cash values are not subject to the market risk associated with longer-term municipal bonds and other longer-term fixed income investments;
- Regular savings are encouraged as an additional advantage for those saving with a whole life policy;
- Favorable tax treatment is a relative matter, depending on changing individual circumstances and investment alternatives;
- Life insurance policies can be used as collateral or security for personal loans.
- Permanent insurance protection for the "whole" of life;
- Life insurance proceeds are not part of the probate estate if named as the beneficiary of the policy; and
- Interest accumulated through the investment portion of a policy is tax-free until it is withdrawn.

2. Disadvantages

The following would be considered **disadvantages** of whole life policies when compared with other types of life insurance products:

- The premium may be unaffordable for persons of limited financial resources.
- Younger individuals are often not able to purchase the amount of death benefit needed and will often be underinsured if they choose whole life insurance as their only life insurance coverage.
- Interest paid on policy loans is generally nondeductible.
- If a policy loan is taken, it reduces the death benefit.
- Lifetime distributions of cash values are subject to income tax to the extent attributable to gain in the policy.
- Surrender of the policy within the first 5–10 years may result in considerable loss, because surrender values reflect the insurance company's recovery of sales commissions and initial policy expenses.
- Erosion of purchasing power is present with whole life insurance because of a fixed-dollar savings medium, and it is adversely affected by inflation.
- Heavy front-end expenses accompany whole life policies.
- The overall rate of return on the cash values inside of the traditional whole life contract has not always been competitive in a before-tax comparison with alternative investments.

- It is often impossible for a policyholder to determine the true rate of return in a whole life policy since the mortality and expenses deducted from the premium are not disclosed.

Chapter Complete

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