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Workings of Adjustable Life Insurance

Even though adjustable life is a flexible-premium type of cash value insurance and can take on the form of almost any traditional term or whole life policy, it provides less flexibility to adjust premiums and death benefits than a universal life policy.

Generally, universal life policyowners may vary their premiums at will or skip premium payments altogether if the policy has sufficient cash values to cover mortality and expense charges. Adjustable life insurance policies cannot be set to zero without policy lapse or invoking the automatic policy loan provision, unless the policy is in paid-up status. The minimum annual premium is typically equivalent to the premium for a 5-year term policy. In contrast to universal life insurance, once a policyowner has selected a given plan of insurance, premiums must be paid as scheduled unless the policyowner notifies the insurer of a desire to change the insurance plan. These advance requests for change in the premium payment plan, face amount, or duration of coverage may be limited or restricted to specific dates or intervals.

Because adjustable life insurance earns dividends rather than interest, it is important to understand how dividends work. Adjustable life is a "bundled" product, which means that expenses, mortality assumptions, and the company's investment performance are lumped together when determining the rate at which dividends are credited. The advantage of dividends in the adjustable life insurance product is that policyowners can receive dividends in a variety of ways. Dividends can be:

- Applied to increase cash value. This option lengthens the protection period or increases face amount;
- Used to shorten the payment period so the policy becomes paid-up sooner; or
- Accumulated with interest or taken in cash.

The dividend option can be changed at any time, depending on the customer's needs.

Adjustable life insurance offers conventional dividend options, such as cash, premium reduction, accumulate at interest, and paid-up additions. Some policies also offer what is called a **policy improvement dividend option.** With this option, the dividends become part of the cash value and lose their separate identity afterward. If the plan of insurance is equivalent to some form of whole life insurance, this option causes the face amount to increase without an increase in premiums or changing the premium-paying period.

If a policyowner decides before 5 years are up that he or she wants a lifetime protection policy, this is not a problem with adjustable life because the premiums can be increased and dividends can be used to lengthen the protection period. As his or her income increases, he or she can decide to increase the coverage to fit a new lifestyle.

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A. Fees and

With an adjustable life policy, the costs of administration, recordkeeping, and service are generally somewhat higher. It is also possible for the insurance company to face greater risk of adverse selection. Policyowners have more latitude to exercise their rights to increase or decrease the face amounts and reduce premium payments without reducing the face amount when health declines.

Considering all of these aspects, expense charges and mortality charges tend to be somewhat higher in these policies than in otherwise compatible fixed-premium, fixed-benefit policies. Life insurance companies are free to set their premiums according to their own marketing strategies. The premium includes a loading to cover such things as commissions to agents, premium taxes payable to the state government, operating expenses of the insurance company (such as rent or mortgage payments and salaries), and any other applicable expenses.

Most of an insurance company's expenses for a policy are incurred when the policy is issued. It may take the company 5 years or longer to recover all front-end costs. The state premium tax is an ongoing expense that averages about 2.5% of each premium payment. Some insurance companies pay 55% first-year commissions to the agents when the plan of insurance is similar to an ordinary whole life policy.

In the case that the insurance company offers a "no-load" or "low-load" life insurance policy, there are still certain expenses that are unavoidable. Rather than pay no or very low sales commission, the cash value tends to build up larger in the early years. Even though the commissions are lower, these companies typically must spend more money on alternative methods of marketing and may therefore incur higher expenses in this area than companies that pay commissions to agents. Many of the adjustable life policies have no explicit surrender charges. However, some will pay a terminal dividend when the policy is surrendered.

The terminal dividend is typically higher the longer the policy has remained in force. This is really a form of surrender charge, because the company is holding back dividends that it could otherwise pay. This rewards policyowners who maintain their policy longer with a greater terminal dividend.

B. Adjustable Life Insurance and Taxation

Generally, policies are taxed in much the same manner as other life policies. Death benefits do not usually have federal income tax consequences. Adjustable life insurance policies are subject to the same income tax and estate, gift, and generation-skipping transfer taxation rules as all other types of life insurance policies. Living benefits from adjustable life insurance policies are also taxed in the same way as living benefits for other life insurance policies.

Except for annuity-type distributions, living benefits are generally taxed under the cost recovery rule. The **cost recovery rule** is sometimes called the **first-in-first-out rule.** This rule treats amounts received as nontaxable recovery of the policyowners

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receive a MEC classification penalty. Under the MEC classification, the distributions are taxed under the interest-first rule rather than the cost recovery rule. If the distributions occur before the policyowner is 59½, dies, or becomes disabled, there will be an additional 10% penalty.

A MEC classification results in a faster taxation of investment gains and a possible penalty tax for early receipt of that growth. The non-annuity living benefits, such as policy loans, loans secured by the policy, loans used to pay premiums, and dividends taken in cash, are the contract distributions referenced in the preceding paragraph. Not included in the contract distributions are dividends used to pay 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.

There are certain changes that can take place in adjustable life insurance that cause it to fall into a MEC classification:

- A material increase of the death benefit;
- An increase in the premium payments;
- A change in the plan of insurance; or
- A reduction in the death benefit.

D. Adjustable Life Insurance and Business Insurance

Adjustable life also can be a great product for funding business plans. The flexibility of an adjustable life policy makes it suitable for many business life insurance needs.

Adjustable life offers a conservative and guaranteed vehicle for all sorts of business applications in which adjustments in death benefits or cash accumulations are frequently required, including split dollar plans, nonqualified deferred compensation plans, death benefit only plans, key-person insurance, buy-sell agreements, retiree benefits funding, and qualified retirement plans that use insurance.

A salary increase rider can be attached to adjustable life policies to increase the face amount, using a multiple of salary. *For example*, if the face amount is two times the salary, as an executive's salary increases, so would the face amount of the policy. The executive bonus plan allows the business owner to bonus the amount of premiums to the employee, thus treating it as compensation and receiving a current tax deduction for the business.

E. Advantages and Disadvantages of Adjustable Life Insurance

As life changes, so do financial goals and the need for protection. Adjustable life can help simplify insurance coverage by offering lifelong flexible coverage in a single policy. This means the policyowner has only one policy to deal with — one premium notice, one set of cash values, and one beneficiary designation. Policyowners save money because costly policy fees aren't paid for additional policies.

1. Advantages

Adjustable life policies provide the following advantages to the policyowners:

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- Offering r Quiz policies.
- Allowing a policyowner to take advantage of tax-deferred growth. At any time, the policyowner can accelerate cash value growth and build toward specific long-term financial goals by paying in addition to regular premiums.
- Giving a policyowner a competitive return on cash value. Adjustable life insurance invests cash value at market rates.
- Free transfers between subaccounts allow the policyowner to adjust the investment strategy according to personal goals and priorities.
- Access to cash values through policy loans and partial withdrawals. Loans and withdrawals may reduce the cash value and death benefit of the policy.
- The requirement to pay scheduled premiums under the selected plan of insurance provides a "forced saving" feature.

2. Disadvantages

Although adjustable life policies offer certain flexibility and convenience to the policyowner, it still contains too many elements of traditional life insurance policies. The following would be considered disadvantages of adjustable life policies compared to other flexible premium policies:

- Surrender of the policy within the first 5 to 10 years may result in considerable loss, because cash surrender values reflect the insurance company's recovery of sales commissions and initial policy expenses;
- Restrictive withdrawal rules;
- Flexibility to change premium payments and death benefits may inadvertently cause the policy to become a modified endowment contract (MEC) with adverse tax consequences;
- Lifetime distributions or withdrawals of cash values are subject to income tax to the extent attributable to gain in the policy; and
- Interest paid on policy loans is generally nondeductible.

Since the development of universal life products, there are now few insurers that market adjustable life policies.

F. Consumer Application

Scenario #1: A real estate broker specializes in large ranch properties. This year he has sold more properties than any other year and acquired some investment properties, financed with long-term, fixed-interest mortgages. He does not want to commit to long-term payments because his sales commissions fluctuate year to year, but he wants to protect his estate from estate taxes while covering the substantial mortgages he just started. He hopes to buy more properties in about 3 years, which will increase his need for protection. Often in his career he has needed access to his money relatively quickly in order to "close a deal." He is concerned that more investments might mean that he would have to pay more in income taxes, which he does not want to do.

Adjustable life allows flexible premiums and tax-deferred cash accumulation. Many adjustable life plans allow an increase in face amount after 3 years, so the broker could increase his coverage when he acquires more mortgages. The plan also allows for a face amount decrease when his obligations are lower. Loans allow him to access cash values.

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The nonprofit could secure charitable adjustable life (CAL) on its members. After the donors complete a simple medical form and give donations, the organization establishes the CAL. Later, the cash values are available to the organization, and upon the members' demise, the face amount goes to the organization.

G. Suitability

1. Suitability Checklist

What are your primary objectives in obtaining life insurance coverage?

_____ Asset preservation
_____ Debt protection
_____ Death benefit for heirs (liquidity for taxes)
_____ Funeral expenses
_____ Income replacement (major wage earner)
_____ Business continuity
_____ Charitable gifting
_____ Retirement supplement

Which of the following statements best summarizes your financial objectives?

_____ My goal is to pay a low premium and have death benefit protection for a limited time.
_____ I want death benefit protection and access to cash values for life.
_____ I want to be able to access cash values in the future.
_____ I want death benefit and premium guarantees.
_____ I plan to keep this policy in force for at least 15 years.
_____ I am concerned about inflation and want to take steps to reduce its impact on my future finances.
_____ It is important for me to be able to change the underlying investments in my policy.
_____ It is important for me to be able to increase or decrease the policy death benefit.
_____ It is important for me to have some flexibility in premium payment amounts.
_____ I am comfortable with some risk to principal because it offers the best potential for long-term results.

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