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## Universal Life Insurance Overview

Universal life insurance provides insurance protection with the guarantee against **lapse** as long as the insured pays a certain premium amount. Two different universal life insurance policies have a guaranteed minimum interest crediting rate, plus features that can be adjusted as the person's needs change and riders that can be added to customize coverage.

### A. Defining Universal Life Insurance

Universal life is a cross between term insurance and whole life with an investment fund that generally has a minimum earnings rate. The premium is flexible, giving the insured the option of adjusting it from year to year, paying a lower or higher premium amount, and even skipping premium payments, as long as the cash value is sufficient to cover all of the costs of the insurance.

The amount of insurance can be changed as circumstances change throughout life. Consequently, the **death benefit** can be raised or lowered, although increases in the death benefit may require proof of **insurability**. The policy is interest-sensitive, meaning that a credit of the current interest rate is applied to policy values.

Universal life contracts separate the protection, expense, and cash value elements. Dividing the policy into these three components allows the insurance company to build a higher degree of flexibility into the contract. This flexibility allows the **policyowner** to modify the policy **face amount** or premium in response to changing needs and circumstances.

A monthly charge for the protection and expense elements is deducted from the policy's account balance. The remainder of the premium is allocated to the cash value element. Complete **disclosure** of internal charges against the cash value element is provided to the policyowners in the form of an annual statement.

In many situations, the combination of low term insurance rates, a competitive yield on cash value, and tax benefits makes the universal life **contract** a viable alternative to more conventional insurance approaches.



## B. Front-End and Back-End Loads Feature

A **front-loaded policy** is a universal life [insurance policy](#) in which most of the expense charges take the form of deductions from each premium payment. Such deductions continue throughout the premium payment period and include annual administrative fees, a premium tax in some states, an annual mortality and risk-expense guarantee fee, and the management fees for running the investment funds.

A **back-loaded policy** is a universal life [insurance policy](#) in which most expense charges occur only if and when the [policyowner](#) surrenders the policy or makes cash withdrawals from the policy. Such charges are usually highest in the early policy years and often are eliminated at the end of a certain number of years.

Initially, universal life products came with **front-end loads**, which are the acquisition expenses taken out of the first premium payment(s). Subsequently, many companies have changed to a back-end load format, in which penalties are applied if the product is canceled during the early years. For a period of time, the cash account will be lower than the accumulation account. This is because universal life is usually back-loaded. Until the expense load has been paid, the money that can be withdrawn is less than the total earned in the reserve account. Once the two merge, the load has been paid in full.

The result of front-end loads will be seen in the first couple of years in a universal life policy because the cash value is equal to zero when the insurance company deducts certain expenses. Over the life of the policy, however, there is a steady increase in the amount of the cash until the age of maturity, when the cash value is equal to or exceeds the policy's [face amount](#).

The big attraction to universal life policies was the high advertised interest rates being paid on the savings portion of policies. The [policyowner](#) will have a front-end load charge for commissions on each contribution. There will not be a front-end load if part of the contribution is used to pay policy premiums. Other front-end loads may include

annual administrative fees, a premium tax in some states, an annual 1% mortality and risk-expense guarantee fee, and the management fees for running the investment funds. Two cash accounts are kept on a universal life policy: an accumulation account and cash value.

This is because some universal life is **back-loaded**. This means that expenses such as commissions, which are usually front-loaded in whole life or term life, are only charged in the event of a withdrawal or surrender in the universal life policy.

Of course, a policyowner can elect to have a front-loaded policy. However, until the expense load has been paid, the money that he or she can withdraw is less than the total earned in the reserve account. Once the two merge, the load has been paid in full. Universal life policies allow a policyowner to increase the coverage without loading the costs and expenses all over again. The insurer will, however, have the right to make sure that an individual remains insurable. Universal life insurance policies are more easily unbundled, so each month the policyowner receives a statement showing the front-end and back-end loads.

## C. Features and Benefits of Universal Life Insurance

Universal life insurance separates the **death benefit** feature from the investment feature and offers increased flexibility for premiums. In a typical universal life policy, the insured may raise or lower the premiums on an annual basis, making this type of policy more of an investment vehicle than pure insurance.

An attractive feature of universal life insurance is that the insured can vary his or her annual **death benefit** and premium. Additionally, the insured may make partial surrenders of and take policy loans against the cash value of the policy. In years when earnings are good, the insured can put more money in the cash portion of the policy and get a faster buildup of the cash value. In years when earnings are not as good, the insured may skip paying the premium altogether or pay less than the total premium.

If the insurance company can offer a high return, an insured may want to raise his or her contributions to the policy to earn the better return that accumulates tax deferred. In a whole life policy, the insurance company essentially guarantees a fixed rate of return on the built-up cash value. In a universal life **insurance policy**, the company adjusts the interest rate from time to time. This adjustment in the rate of return allows the universal life policy to stay competitive when rates on alternative investments are rising.

Many universal life policies also will allow the insured to determine whether to allocate policy premiums to the **death benefit** or to the investment feature of the policy. Universal life policies often do not require repayment of a policy loan.

The following are **advantages** of universal life:

- It is a cash value policy, which can provide cash to offset increase mortality charges as the insured ages.
- It has the features of business insurance and individual coverage.
- It is a flexible **contract**, allowing the insured considerable latitude in selecting a premium payment amount and a **death benefit**. Most individuals or families experience financial ups and downs and it can be beneficial for a **policyowner** to be able to omit premium payments for a year or two when finances are tight.
- The inside buildup of universal life insurance is tax-deferred.
- It has flexible investment options for the policyowner. This is a decision made not only on the day an individual decides on a specific **face amount** of life insurance

and puts the policy in force; it continues to be an important decision throughout the life of the contract.

- The funding strategy can be divided into the following 6 levels (described in detail later):
  - Underfunding;
  - Parity funding;
  - Minimum funding;
  - Adequate funding;
  - Investment funding; and
  - Maximum funding.

Additionally, Universal Life, like many other life insurance products, provides protection from creditors' claims, offers a [policyowner](#) loan provision, provides tax benefits if the policy matures as a death claim, and offers a semi-compulsory savings feature with professional money management.

Universal life generally has lower premiums than whole life but gives policyowners many of the benefits of whole life, including cash build-up values, control over the level of premium payments, and control over the amount of their death benefits. The tradeoff is that the cash build-up of universal life policies is not necessarily fixed or guaranteed, as with traditional whole life policies. Instead, it is linked to the performance of the funds in which premium dollars are invested.

## 1. Types of Funding

**Adequate funding level:** Adequate funding is a level of payment designed to allow the [policyowner](#) to arrive at parity funding at some particular point in time. **Adequate** is an amount of money that covers all current expenses and mortality charges and also makes a significant investment into the policy. *For example*, if approximately \$6,000 in capital is needed to reach parity funding and an individual does not have \$6,000 to put into the policy immediately, that individual may decide on an investment of \$100 per month or \$1,200 a year.

**Underfunding level:** Underfunding of universal and variable universal life policies occurs when the mortality and expense charges exceed the combined total of the investment earnings and current yearly payment into the policy. When the [policyowner](#) examines the policy, he or she may find that expenses incurred for the year were \$50 and mortality costs were \$450, totaling \$500 in costs for that particular year.

**Parity funding level:** "Parity" is the quality or state of being equal. The primary objective of the life [insurance policy](#) is to provide insurance protection on the life in the amount deemed necessary. The [policyowner](#) will want to pay for this insurance in the most efficient way possible. The **parity funding level** in a life insurance policy is the point at which the amount of capital invested inside the policy will earn enough nontaxable return in the year in question to pay all of the mortality and expense charges within the policy in that year. There is "parity" between policy earnings and policy costs.

**Minimum funding level:** The minimum funding level should be the level at which the interest earnings in the policy and the policyowner's contribution to the policy are no less than the amount of the mortality and expense charges in the policy in that particular year. Such a funding level will ensure that the capital accumulated within the [contract](#) will stay at a constant level for the year and will not be depleted by policy costs. It's an advantage to own a policy where a policyowner can adjust the premium

level back to that of a straight term policy during those times when he or she does not have extra money to invest in the policy.

**Investment funding levels:** If a [policyowner](#) has reached the parity funding level, and policy earnings are sufficient to cover all policy expenses, why would he or she choose to invest even more capital into an investment fund? A policyowner would do that to earn more for himself or herself, for an emergency fund, for college education funds, and for eventual retirement, taking advantage of the protection from income taxes provided by the policy. Many participate in successful mutual funds and use them appropriately to build family wealth. Such mutual funds outside of the life [insurance policy](#) require the payment of taxes each year on any earnings and capital gains realized.

**Maximum funding:** The maximum funding level is based on the policy [death benefit](#), age, and the person's gender. It is the point at which no additional funds can be added to the policy, based on the controlling income tax provisions in Internal Revenue Code Section 7702. The insurance company will determine what the amount is for each [policyowner](#). According to the tax code, funding above this level causes the policy to cease to be a life [insurance policy](#), resulting in immediate taxation of all deferred earnings. The insurance company should not accept money that would cause the policy to go above maximum funding.

## 2. Death Benefit Options

Universal life has two kinds of flexible death benefits:

1. A level death benefit that remains at a constant level for the life of the [contract](#), regardless of the performance of the cash values. This is the death benefit that is very similar to whole life insurance, in that the cash values are returned at death as a part of the death benefit (usually called **Option A Death Benefit**); and
2. A death benefit that pays the [face amount](#) of coverage purchased plus the accumulated cash value. This is usually called **Option B Death Benefit** and, as you might guess, requires a considerably higher premium outlay.

The Option B Death Benefit not require any future medical or financial justification to be submitted to the insurer for the increase in [death benefit](#) due to the cash value accumulation being paid in addition to the policy [face amount](#). Regardless of which death benefit option is chosen initially, some insurers allow a limited amount of switching between the two after the policy is in effect. The Death Benefit Option elected by the [policyowner](#) directly affects the net amount of death benefit risk that the insurance company is exposed to. The size of the amount at risk, in part, determines the internal amounts charged for the term insurance expense.

Universal life insurance has three areas in which a [policyowner](#) can choose either a level or adjustable option. These three areas are premiums, coverage, and death benefits. The premiums are adjustable by building the cash value so that it can make the entire payment or part of the payments. The coverage is adjustable because of the performance of certain assets held in the company's general account. The death benefit options include Option A or Option B.

Under Option A, the policyowner purchases a death benefit that does not include the accumulated cash values, so the net amount of death benefit risk the insurance company is exposed to decreases as the cash value increases, and the amount of mortality risk that must be purchased decreases. Under Option B, the policyowner purchases a death benefit that includes the accumulated cash values, so the net amount of death benefit risk the insurance company is exposed to does not decrease

as the cash values grow and the amount of mortality risk that must be purchased also does not decrease.

### Option A - Level Death Benefit

Under Option A of universal life insurance, there is a level **death benefit**. A **policyowner** stipulates to the insurance company the total amount of the death benefit that is to be payable to the beneficiaries. If a policyowner stipulated Option A, the investment results in the policy will have no impact on the death benefit.

If he or she has elected \$200,000 as the **death benefit** under an Option A policy, that's exactly what the beneficiaries will receive. If he or she had paid \$50,000 worth of premiums and had investment results that doubled that amount, the account value would be \$100,000. The insurance company would still pay a total of \$200,000, \$100,000 of which would be the account value and \$100,000 of which would be insurance company money.

*For example*, a **policyowner** transfers \$10,000 from a CD into an Option A Universal life **insurance policy**, but dies immediately thereafter. The insurance policy pays \$200,000. The day before, while the CD was still in the bank, he had a \$200,000 life insurance policy and a \$10,000 CD. Had he died at that point, the **beneficiary** would have received both the \$200,000 and the \$10,000 CD. The instant the insurance company received the CD for deposit into an Option A policy, the insurer reduced the "net amount at risk."

For this reason, a **policyowner** should avoid an Option A policy during the accumulation years, unless he or she has a specific reason for selecting this option. The **face amount** is the **death benefit** and includes the value of the investment account. *For example*, the face amount/death benefit is \$200,000 on Option A. The policy account value is \$100,000. The amount at risk is \$100,000. The death benefit will be \$200,000.

### Option B - Increasing Death Benefit

Under Option B, the **death benefit** is equal to a specified amount, plus the policy's current cash value. With Option B, under normal circumstances, the death benefit increases. Consequently, the **face amount** will not change, but the actual death benefit payable will be reduced because of the reduction to the cash value. It is possible to withdraw cash value without affecting the death benefit if the policy is not written in the Option B format. This will shorten the policy's lifespan.

When a policyholder elects Option B, he or she directs the insurance company to pay the stipulated benefit from its money, not the policyowner's money. Instead of having the \$200,000 death benefit included in the investment account, the policyowner asks that the investment account be paid in addition to the amount at risk of \$200,000.

By electing Option B in the previous example, when the individual transferred the \$10,000 into his investment account, that investment account would increase by \$10,000. In the event of death, the life insurance (\$200,000, which is the amount at risk) and the investment account (\$110,000) would be paid to the beneficiary, for a total of \$310,000. The death benefit is the face amount plus the value of the investment account.

A policyowner maintains control over the death benefit with Option B. If he or she wants the insurance company to reduce the amount at risk, he or she can direct the insurance company to reduce the face amount of the policy to the predetermined level. The insurer will do so and thereby reduce the mortality costs. A policyowner

must be cautious about asking for any reductions in the death benefit of the life [insurance policy](#), particularly during the first 15 years of the policy's life.

**Force out** means that there is too much cash in relation to the [face amount](#) of the policy. The insurance company is forced to take money out of the policy and return it to the [policyowner](#) to remain in compliance with the definition of life insurance in IRC 7702. Money forced out in this manner will trigger ordinary income tax on the amount forced out to the extent of gain in the policy, in addition to possible 10% penalties.

The optional solution may be for the policyowner to use Option B in a [contract](#). It is best if the policyowner avoids a reduction of the face amount during the first 15 years of the policy life. It is best if the policyowner considers the potential income tax implications of any changes. When the policyowner works closely with the insurance company and their advisor, he or she will avoid income tax surprises.

## D. Consumer Application

A rising litigation attorney needs insurance to protect her family. Because her children are young and her career is in the beginning stages, guaranteed death benefits are important to her. She expects that her income will increase, along with her taxes. A large case she has just won will settle sometime in the next 2 years. There is also a chance that in 5 years she will take a couple of years off to have another child. She is not particularly good at saving money and, given her area of law practice, would like to shelter assets from creditors. She considers herself an aggressive investor and wants to start a retirement savings.

Universal life gives this insured the option to vary the death benefit and the annual premium. If accumulations are sufficient, the insured can skip payments or pay less than the total premium. The plan offers a semi-compulsory savings feature along with professionally managed funds for her cash accumulation. It can offer some protection from creditors.

## Chapter Complete

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