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## Variable Universal Life Insurance

Variable universal life insurance is a product with many of the attributes of both variable life and universal life. Like variable life, the **policyowner** can allocate the investment of cash values among the subaccounts in the **contract**.

Like universal life, the policyowner has several **death benefit** options to choose from. The cash value of the policy will fluctuate based on the performance of the selected subaccounts and, depending on the death benefit option chosen, the death benefit may fluctuate as well. Taxation of variable universal life is the same as variable life including the potential for the product to be classified as a modified endowment contract and experience adverse tax consequences.

### A. Definition of Variable Universal Life Insurance

Since variable universal life insurance allows the cash values to be invested in securities products, it is regulated by both federal and state securities laws as well as state insurance laws. Agents must hold both insurance and securities licenses to sell the product and a prospectus must accompany each solicitation.

### B. Features and Benefits of Variable Universal Life Insurance

A variable universal life insurance **contract** combines features of variable and universal contracts. The insured's cash value account varies based on the performance of the underlying investments within the subaccounts, and the insured can adjust the premium amount or face value of the contract. Subaccounts options typically include stocks, bonds, balanced, or money market accounts. There is also usually a fixed account with a minimum guaranteed rate of return.

#### 1. Guaranteed Death Benefit

Under **death benefit** Option A, the variable universal life policy guarantees that as long as the minimum monthly premiums are paid, regardless of investment performance, the policy remains in force with the death benefit guaranteed to be no less than the **face amount** chosen at time of policy issue or the current face amount if the **policyowner** adjusted the face amount subsequent to policy issue. Death benefit Option A pays only the face amount of the coverage purchased and does not pay cash values in addition to the policy face amount.

Under death benefit Option B, the variable universal life policy guarantees that as long as the minimum monthly premiums are paid, regardless of investment performance, the policy remains in force with the death benefit guaranteed to be no less than the face amount chosen at time of policy issue or the current face amount if the policyowner adjusted the face amount subsequent to policy issue. Death benefit

Option B pays the face amount of the coverage purchased plus the accumulated cash value. Many variable universal policies also offer a third death benefit (usually called Option C).

Option C varies from company to company but the most common is illustrated below:

Typical death benefit Option C: Death benefit equals face amount of the policy plus all premiums paid into policy, less any policy loans or partial withdrawals. This death benefit option is sometimes called “return of premium.”

## 2. Multiple Liquidity Benefit

Variable universal life insurance offers access to the cash values in an individual's policy. This access includes the following:

- Loans for retirement with no net interest charge;
- Partial withdrawals of cash values, subject to a minimum withdrawal amount and a partial withdrawal charge;
- Regular policy loans at a low net interest charge; and
- Surrender of the policy at any time, subject to a declining and eventually disappearing surrender charge.

## 3. Flexible Premium Feature

After the first policy year most VUL contracts allow the [policyowner](#) to increase or decrease the premium payments, make payments more or less frequently, skip payments, or discontinue payments for periods of time (provided that the policy's cash value is sufficient to cover continuing policy charges).

This adjustable premium feature necessitates that a report must be sent to the policyowner whenever total charges authorized by the policy that are necessary to keep it in force exceed the amounts available within the policy to pay such charges.

## 4. Level or Adjustable Premium

As discussed earlier, the [policyowner](#) of a VUL policy has a fair amount of latitude over how much and when premiums are paid. However, the amount of premiums paid is subject to minimum premiums necessary to support the policy [face amount](#). In addition, premiums are subject to maximums. In order to prevent a VUL [contract](#) from being taxed as a modified endowment contract, insurance companies use one of two different tests that are considered safe harbors. These two tests are the cash value accumulation test (CVAT) and the guideline premium test (GPT). The average policyowner does not have the ability to monitor the policy under either of these tests so the insurers routinely test policies to ensure compliance.

## 5. Investment Selection Option

Most variable universal life policies offer several subaccounts for the [policyowner](#) to allocate among. The policy owner is usually allowed a fixed number of re-allocations per year without an additional charge. Often the allocations are limited to a minimum dollar or percentage, such as a minimum of \$2,500 or 10% of cash values to each subaccount.

## 6. Payment of Policy Proceeds Feature

Variable universal life offers several [death benefit settlement options](#), such as a lump sum death benefit, payments for a fixed period, payments for a minimum fixed period or life (whichever is longer), fixed amount payments with interest accruing, joint and

survivor lifetime income, payments of interest only with the remainder to a specified beneficiary, or installment refund.

## 7. Customized Policy Design Feature

Within the limits of the policy, a **policyowner** can customize variable universal life to fit their needs and adjust the policy as their needs change.

## 8. Fixed Value Account Feature

Many variable universal life policies offer a fixed value subaccount where a minimum interest rate and safety of principal is guaranteed. This fixed value or fixed rate account can be utilized by the **policyowner** to segregate some of the cash values into a guaranteed environment.

## 9. Tax-free Access and Transfers

With life insurance, increases in cash values resulting from investment income are not taxable as long as the policy remains "in force." If a policy is surrendered, the amount received, including any existing policy loans, is taxable as ordinary income to the extent of gain in the policy (if any). Cash withdrawals from such policies generally are taxed only to the extent that a withdrawal exceeds investment in the policy, and policy loans generally are not treated as taxable distributions. However, withdrawals during the first 15 policy years that result in a reduction in death benefits can trigger income taxation of gain.

## 10. Borrowing

Loans can be made against the accumulated cash value of a VUL policy; however, this is not without risk to the viability of the **contract**. Accessing cash values through a loan may significantly affect current and future contract values or death benefits. Many VUL policies include a "no **lapse** guarantee" which is benchmarked to establishing and maintaining certain minimum account values. The minimum account value is negatively impacted by policy loans, so the act of taking a loan (depending on the loan amount and the contract value immediately prior to the loan) could void the no lapse guarantee.

## 11. Liquidity Features

Several liquidity features unique to the variable annuity make penalty-free withdrawals available for certain unexpected life events:

- Involuntary unemployment;
- Total disability;
- Terminal illness;
- Nursing home confinement; and
- Divorce.

**Policy loans** are available at an attractive interest rate at any time after the first policy year. Beginning in the 11th policy year, loans are available at zero net cost. A **withdrawal (partial surrender)** up to 10% of policy value is often available after the first year without triggering surrender charges or a withdrawal fee. A **portion of death benefit** is available if one is diagnosed with a terminal illness and has a life expectancy of less than 12 months. The policy may be **surrendered** at any time for its accumulated value. Charges and penalties may apply. Investors may also have to pay income taxes and tax penalties on any money withdrawn.

*Note that these liquidity features may not be available in all states.*

## 12. Flexible Coverage

Most insurers require a minimum **face amount** of at least \$50,000 of coverage to issue a VUL policy. Once the policy is issued, the **death benefit** can be adjusted up or down but cannot be reduced below the minimum required face amount for policy issue. Proof of **insurability** may be required for face amount increases, rates are almost always attained age, and increases or decreases in the face amount are usually required to be in increments of \$10,000.

### C. Consumer Application

A 50-year-old fashion designer married a 55-year-old wealthy department store chain owner. An unfortunate skiing **accident** took the storeowner's life just after he retired and his wife inherited his estate. Now aged 52, the woman wants to preserve her estate for her children and cover her inevitable estate taxes, at least until she retires completely at age 70. In addition, she wants tax-deferred growth and to be able to borrow or withdraw funds to pay for potential business expansion opportunities. Having just settled her husband's estate, she has a lump sum available to fund this purchase. Because her business operations take so much of her time, she does not want any more bills to pay. She is bullish on the economy and considers herself to be an aggressive investor.

In this situation, variable universal life is an option because it

- Allows a lump-sum premium payment;
- Can guarantee coverage to age 70;
- Allows tax-deferred cash accumulation;
- Allows additional payments to increase cash values;
- Offers liquidity in the form of withdrawals and loans; and
- Has a choice of investments that can potentially increase the cash value.

### D. Advantages and Disadvantages of Variable Universal Life Insurance

Variable universal life insurance has advantages and disadvantages for individual policies, as well as business insurance. It can be used to provide potentially higher tax-deferred cash value accumulations in nonqualified deferred compensation plans than traditional policies or even universal life insurance.

On the other side, there are more investment risks involved with variable universal life insurance. If the investment performance is poor, the **policyowner** may be required to pay additional premiums to maintain the **face amount** of coverage.

#### 1. Advantages

- Variable universal life enables one to make withdrawals or borrow from the policy during his or her lifetime, and it offers separate accounts in which to invest.
- By contributing at regular intervals through dollar-cost averaging, a **policyowner** may get a lower overall cost on the units in which he or she is investing, without having to time the financial markets.
- The policyowner is never locked into an investment choice. The policyowner can also secure any gains made by transferring them into the cash management portfolio, or the fixed account on a limited basis. Those earnings can then remain there tax-deferred.
- A variable universal life policy provides **death benefit** assurances that the policy will continue in force for the guaranteed period, no matter what the investment performance of the subaccounts may be, as long as the required premiums are paid.

- When a disability benefit **rider** is added, it makes the minimum premium payments into the policy after the insured has been totally disabled for 6 months, which keeps the policy in force, including the insurance and investment components.

## 2. Disadvantages

- It requires the policyholder to devote time in managing the policy's accounts. The policy's success depends on the investments made.
- Premiums must be high enough to cover insurance and provide for cash value accumulation. It doesn't work well with small premium amounts because the premium must cover insurance and accounts.
- Loans and withdrawals will reduce a policy's cash value and **death benefit**. Depending upon the performance of the underlying investment options, the cash value available for loans and withdrawals may be worth more or less than the original amount invested in the policy. There may be substantial penalties and fees associated with policy loans and withdrawals. Always refer to the policy prospectus for an explanation of policy provisions, costs, expenses, and risks.

## E. Suitability

### 1. Appropriate Sales

Variable universal life combines the investment risks and rewards of variable life insurance with the ability to adjust premiums and **death benefit**. This type of policy is appropriate for individuals who need flexibility in premium obligations, have a long investment time horizon, and can tolerate the higher amount of risk in the separate account. If the investments in the separate account outperform those of the insurer's general account, there will be a greater financial return than would be received on a whole life policy with the same premium. There are tax advantages, especially for high-earning individuals in the higher income tax brackets. However, these policies are complex and require a significant premium outlay in order to perform well, so they are not appropriate for everyone.

### 2. 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 summarize 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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