

## Variable Universal Life (VUL)

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### What is it?

#### *Permanent (cash value) life insurance with maximum flexibility*

Variable universal life (VUL) is considered the most flexible type of permanent (cash value) life insurance. VUL combines the multiple investment accounts found in variable life (VL) policies with the premium payment flexibility, death benefit options, and withdrawal capability found in universal life (UL) policies. The combination of features from these two types of policies allows you to custom-build a policy that will suit your needs both now and in the future. Due to the nature of the investments (normally called subaccounts), the policy must be registered with the Securities and Exchange Commission (SEC), and agents selling this type of policy must be licensed to sell securities. Additional state regulation may also apply.

VUL is also called flexible premium variable life, modified premium variable life, equity-based whole life, or universal life II. The following table shows the relationship of VUL to UL and VL:

FEATURE	UL	VL	VUL
Flexible premium amounts	X		X
Flexible premium payment timing	X		X
Death benefit options A and B available	X		X
Changes to death benefit allowed	X		X
Choice of underlying investments		X	X

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Policy subject to monthly charges	X		X
Cash values and death benefit fluctuate with underlying investment performance	*	X	X
Guaranteed minimum interest rate on cash values	X		**
Cash value partial withdrawals allowed	X		X
Cash value grows tax deferred	X	X	X
Periodic statements detail monthly cash value growth and deductions	X		X
Considered a security--needs SEC registration		X	X

\*Current interest fluctuates with performance of insurer's general portfolio, but accumulated cash values don't fluctuate with market changes.

\*\*Funds invested with the insurance company's general fund receive a minimum rate of return set by the insurer. Funds invested elsewhere are subject to market conditions. Guarantees are subject to the claims-paying ability of the insurer.

**Caution:** Keep in mind that registering a VUL policy with the SEC does not mean that the policy is endorsed or approved by the SEC.

## When can it be used?

### *You have a need for insurance and want maximum policy flexibility*

When you have a need for life insurance and a desire for flexibility and control in your policy, a variable universal life (VUL) policy may be appropriate for you. With this type of policy, you can design a policy that provides you with a choice of subaccounts and the ability to alter the amount of your premium payments and death benefit.

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### ***You are willing to assume the risks associated with investing***

When you choose subaccounts, you assume the same risks associated with any investment. With a VUL policy, your premiums can be invested more aggressively than with other policy types (such as whole life or universal life). As a result, you have the potential for higher returns. While you could benefit from favorable returns that increase your cash value and death benefit, you could also see a decrease due to market conditions relating to your specific choice of subaccounts.

### ***You have a long-term cash accumulation need (15 years)***

As part of your overall financial plan, you may be accumulating cash for a specific future need, such as supplementing your retirement or paying for your child's college education. A VUL policy can be an important financial-planning tool that provides your beneficiary with a death benefit should you die prematurely. In addition, the policy contains cash values that can be accessed during your lifetime for financial needs. In general, you should have around 15 years before your funds are needed for your specific goal in order for cash values to have time to accumulate to a substantial amount (though there is no assurance they will do so).

**Caution:** Under the modified endowment contract (MEC) rules, there could be tax consequences (in addition to any surrender charges) as a result of significant overfunding of the policy and/or material changes in benefits during the early years of the policy. Consult your tax advisor.

## Strengths

### ***Provides benefits common to all cash value insurance***

Like all other permanent cash value policies, a variable universal life (VUL) policy contains the following features:

- Cash value grows tax deferred
- Cash value can be borrowed against (though borrowing may reduce the policy's death benefit)

For further information, see Policy Types .

### ***Offers maximum flexibility***

VUL policies are the most flexible of the existing life insurance policy types. This type of policy provides you with the ability to choose and make changes to your policy and subaccounts. VUL combines what have been described as the best features from variable life and universal life.

### ***You choose your subaccounts***

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With a VUL policy, you get to choose your subaccounts. You can usually choose more than one type of subaccount and are able to move your money between subaccounts.

**Caution:** There may be a limit on how many times you can move your money between subaccounts in a given time period and/or fees if you exceed a certain number. Check your policy.

### ***Wide variety of investment options available (including insurer's general fund)***

VUL policies offer a number of different investment options. As with variable life policies, the investment options may include foreign stock and bond portfolios, portfolios in specialized industry or economic sectors, and various bond and government portfolios. Large insurance companies often manage their own accounts, while smaller insurers may use outside investment firms that specialize in money management. Typically, you can invest in more than one investment portfolio and can move your funds between portfolios as desired, without incurring tax. Your investments are held in separate accounts and are not part of the insurance company's general fund. In the event of insurer insolvency, these separate accounts may be protected from creditor claims other than claims directly connected with the separate account and the related insurance policies.

In addition to the separate subaccount options, many VUL policies offer the added ability to invest in the insurance company's general fund. Investments in the general fund earn a guaranteed minimum rate of return set (and subject to periodic adjustment) by the insurance company. Even if the insurance company's investments perform poorly, you still receive the guaranteed minimum rate of interest on any portion of your cash value invested in the general fund.

**Tip:** If you want to invest solely in the insurance company's general fund, check out universal life insurance.

**Caution:** Guarantees are subject to the claims-paying ability of the insurer.

### ***Provides wide discretion in choosing timing and amount of premium payments—no advance notice needed***

As with universal life, VUL provides for completely flexible premiums. Generally, the policy allows you to increase, decrease, and even skip premiums after the first policy year, as long as the cash value is large enough to cover policy expense charges. You have the ability to change the amount or frequency of your premium payment without giving the insurer prior notice. Most insurers suggest a target premium amount to keep the policy in force, and some insurers may impose a minimum premium amount (in some cases as low as \$25) should you choose to make a premium payment (in other words, no \$5 weekly payments).

**Tip:** Large premium payments in the policy's early years, or at other times when cash is available, can reduce or eliminate the need for premium payments at other times. There may be maximum limits imposed by law to prevent excessive policy funding.

**Caution:** If your cash accumulation value isn't sufficient to cover the current expense and mortality charges, you may be required to make an additional premium payment in order to prevent a policy lapse.

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## ***Offers choice of two death benefit options***

Like universal life, VUL offers you the choice of two death benefit payment patterns:

Option A (sometimes called option I)—This is a fixed death benefit plan, similar to traditional whole life . The death benefit in option A is composed of a pure insurance component plus the cash value. As the cash value grows, the amount of pure insurance is reduced to keep the death benefit constant. The cash value could grow to a level where it could equal or exceed the death benefit amount and therefore cease to be classified as a life insurance contract. In order to avoid this, the death benefit should be increased.

Option B (sometimes called option II)—With this option, the death benefit increases as your cash value grows. Option B operates similarly to a whole life policy, with the term insurance rider equal to the cash value. The death benefit at any time equals a specified level of pure insurance plus the policy cash value. Generally, you are allowed to change from one option to another within guidelines.

## ***You can change the amount of your death benefit***

With a VUL policy, you have the ability to increase or decrease your policy's death benefit, providing versatility within the policy and allowing it to adapt to your changing needs and circumstances. As your insurance needs change with time, you can change your coverage to meet these needs without having to take out an additional policy or surrender an existing one. Increases in the policy's death benefit may require a medical exam for proof of insurability.

**Tip:** Depending on your cash value accumulation, you may be able to increase your death benefit without an increase in premiums. Check with your insurance agent.

**Caution:** Decreases to your death benefit could have tax consequences. See Tradeoffs. Consult your financial advisor.

## ***Fees are fully disclosed—you can see what you pay for***

Whatever type of life insurance policy you buy will have charges for fees and expenses. The key difference with a VUL policy (and a few other types, including universal life) is that the fees and charges are unbundled (fully disclosed in the policy), while other policy types bundle the fees (lump them together) so that you can't identify specific items. Both the charges from premiums and those from cash value are specified. This can make it somewhat easier to compare the fees charged by different policies (although fees and expenses shouldn't be your only criteria when choosing a policy).

## ***Partial withdrawals of cash value may be allowed***

With a VUL policy, you may be allowed to withdraw some of your cash value by making a written request to the insurance company for a partial surrender of your policy (sometimes called a withdrawal of excess cash value). Depending on your specific policy, there may be minimum and maximum amounts that can be withdrawn.

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**Caution:** Many VUL policies include a surrender charge to prevent the cash value from being used as a checking account and to reimburse the insurance company for administrative costs (especially in the early policy years). Surrender charges may apply for as many as 10 to 15 years. Check your policy.

**Caution:** Withdrawals may reduce your policy's death benefit.

## Tradeoffs

### ***Death benefit generally not guaranteed***

Generally, the death benefit with a variable universal life (VUL) policy is neither fixed nor guaranteed and can increase or decrease depending on both the level of cash value in the policy and the death benefit option chosen. With the variable death benefit option (option B), your cash value is added to the specified death benefit amount and can fluctuate daily based on the investment performance of the underlying subaccounts.

Some policies do offer a death benefit guarantee for your peace of mind (though this guarantee will be subject to the claims-paying ability of the insurer). Ask your agent if his or her policy offers this benefit.

### ***Investments outside insurer's general fund not guaranteed***

When you choose a VUL policy and invest in subaccounts other than the insurance company's general fund, the insurer doesn't provide any guarantee of minimum cash value balance or interest rate. Under this type of policy, you assume all the risk and responsibility associated with your investments, just as if you had invested your money on your own. While it is entirely possible that you could see your cash values and death benefit grow, you could also see them decline with market conditions.

**Caution:** Theoretically, your policy cash values could be reduced to zero. If this happened, your policy would terminate.

### ***Large premium payments could mean tax consequences under modified endowment contract (MEC) rules***

The modified endowment contract (MEC) rules must be considered when pre-funding your policy with large premium payments or making material changes to the policy. If your policy is classified as a MEC, any distributions or loans from the policy will be subject to unfavorable income tax treatment and may also be subject to penalties. If you structure your VUL policy to achieve high cash value with high premium payments, you could be a candidate for this tax trap. Consult your insurance agent or financial advisor for more information.

### ***Changes to death benefit level or option could be potential tax trap***

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In order for a policy to be treated as life insurance under the tax code, the insurer must be exposed to a certain amount of risk. A "corridor" must exist between the cash value and the death benefit. In other words, the death benefit can't be composed of cash value only; there must be an insurance element present. If you reduce your death benefit, it could lead to a "force-out"—a distribution of cash from the policy in order to maintain the corridor between the cash value and the death benefit. A distribution resulting from a force-out could be subject to income tax to the extent it represents gain under the policy. A change in the death benefit option from option B (increasing death benefit) to option A (level death benefit) during the first 15 policy years could also result in a force-out and potential taxation.

**Tip:** Check with your insurance agent and/or financial advisor when considering changes to your death benefit level or payment option.

### ***Policy loans affect cash value***

When you take a policy loan, the loan proceeds you receive come from the general fund of the insurance company. The loan amount is not actually withdrawn from your cash value account. However, an amount of your cash value equal to the loan amount is marked as collateral for the loan. The collateral amount doesn't receive credit for the actual returns of the underlying investment. Instead, this amount of your cash value receives credit equal to a specific policy loan rate during the course of the loan. Because a portion of your cash value is not participating in the actual investment return, your cash value growth is affected for the duration of the policy loan.

**Caution:** There is generally no requirement that your policy loan must be repaid, but for any unpaid loan balance, interest accrues on a compound basis. If the value of your outstanding policy loan plus the accrued interest equals the cash value, the net cash value becomes zero and the policy terminates. This could create a large tax liability if your policy had an existing loan and/or cash surrender value totaling more than your cost basis.

### ***Policy loans affect death benefit***

In general, your death benefit has the potential to exceed the guaranteed minimum death benefit when your underlying subaccounts experience favorable returns. However, when there is an outstanding policy loan, a portion of your cash value equivalent to the loan amount receives the special loan policy rate instead of the actual investment return. This can affect the cash value growth, in turn reducing the potential of the death benefit to exceed the guaranteed minimum amount. In addition, if you die with an outstanding policy loan against your account, the insurance company receives the loan repayment from the death benefit first. After the loan is repaid, the balance of the death benefit is paid to the policy beneficiary.

### ***Premium reductions could result in policy lapse***

The ability to reduce or skip premiums could lead to the temptation to actually do so, exposing you to a potential reduction of cash values to low levels (or even worse, to zero). If this happens, you have two choices: pump in lots of money to keep the policy going and cover the increasing cost of insurance, which could be very expensive; or allow the policy to lapse, which leaves you without insurance protection.

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## How to do it

### ***Determine your life insurance need and overall financial goals***

Before you buy life insurance, you need to know how much insurance you need. Insurance need is based on numerous factors, including your current age and income, marital status, number of incomes in the household, number of dependents, long-term financial goals, level of outstanding debt, and existing insurance and other assets. Your overall financial, estate, and tax-planning goals and your planning horizon should be considered as part of your insurance need evaluation. For more information on determining appropriate levels of life insurance, see *How Much Is Enough?* .

**Tip:** Consult with your financial advisor concerning your need for insurance. Some of the calculations can be complicated.

### ***Decide how much risk you are willing to assume***

Your overall attitude toward risk and investing will help determine if variable universal life insurance is an appropriate policy type for you. In general, if you are experienced in equity investments, then variable universal life may fit into your overall financial plan. If you prefer stable, guaranteed returns and steady growth, then VUL may not be an appropriate policy for you due to the daily portfolio fluctuation and the absence of either a guaranteed rate of interest or a guaranteed rate of cash value growth.

### ***Obtain a prospectus for each VUL policy you are considering***

Due to the underlying investment nature of VUL, the Securities and Exchange Commission rules generally require that this type of policy can't be sold without a prospectus that includes full disclosure of all contract provisions, expenses, options, portfolio information, and your rights as a policyowner.

**Tip:** Read each prospectus carefully and compare the different policies before you buy a policy. Pay attention to the investment objectives of each subaccount, expenses and surrender charges, and other fees and charges for the policies you are considering buying.

### ***Choose an insurance amount and death benefit option***

When you buy your VUL policy, you must choose a death benefit amount and option, either of which may be changed at any time. Option A (or option I) pays a level death benefit, while option B (or option II) has an increasing death benefit.

### ***Complete the insurance application and name your beneficiary***

Before the insurance company can issue your policy, it must receive a completed application form. The application includes general health questions, and the process may include a physical

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examination, which is usually paid for by the insurance company. A critical part of the application is the beneficiary designation—the naming of the person or persons to receive the policy proceeds when you die. Unless you make an irrevocable beneficiary designation, you can change the beneficiary designation by adding or removing a beneficiary or changing the percentages of the proceeds distribution.

### ***Buy the policy and pay your premium***

It is all well and good to know how much insurance and what type of policy is appropriate for your particular situation. But if you don't actually buy the policy, you haven't accomplished your goal! Not only that, but insurance becomes more expensive with age, so you won't be doing your wallet any favors by delaying. An additional risk of delaying is that your health could change adversely. In other words, just because you are healthy and insurable today doesn't mean you will be that way later. Deterioration in your health can mean higher premiums or an insurer considering you to be uninsurable.

### ***Review your insurance need periodically***

The amount of life insurance you need may change over time and with the occurrence of lifetime events. As a result, you should periodically review your life insurance coverage. As a rule, you should review your coverage every three years. Major lifetime events (such as the purchase of a home, birth or adoption of a child, and a change in marital status) are also appropriate times to review your coverage. By routinely checking your insurance need, you can prevent the mistake you can't fix after you die: not having enough life insurance.

### ***Change your premium amounts and/or death benefit as desired***

After you have paid your initial premium, you may be allowed to increase or decrease the amount of your premiums. You may even be able to skip premiums, as long as your cash value account has a sufficient balance to cover the cost of insurance and any expenses. Generally, you can change your death benefit and/or premium amounts to meet your changing need for insurance coverage over time.

## **Tax considerations**

### **Income Tax**

#### ***Premium payments not deductible***

Life insurance premium payments are generally not tax-deductible expenses.

#### ***Policy loan proceeds generally not taxable***

When you take out a loan against your life insurance policy (except a modified endowment contract, or MEC), the amount you receive is not considered taxable income. This rule applies even when the loan is larger than the amount of premiums you have paid in (except in the case of an

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MEC).

**Example(s):** You own a VUL insurance policy (non-MEC) with a cash value of \$20,000. Your basis in the policy is \$14,000. You decide to take a policy loan to pay your daughter's college tuition. Under the terms of your policy, you are allowed to take a loan for an amount up to 75 percent of the policy cash value—in this case, \$15,000 ( $\$20,000 \times .75$ ). You are not currently subject to tax on the amount of the loan, even though the loan is larger than your basis.

**Caution:** If you cancel your policy while there is a loan balance outstanding, you could be subject to income tax on the amount of the loan (plus any accrued but unpaid interest).

### ***Policy loan interest not deductible***

Interest you pay on a policy loan is not a tax-deductible expense when the loan is for purposes other than business or investments.

### ***Policy cancellation may be taxable***

If you cancel (surrender) your policy for cash, the gain on the policy is subject to federal income tax. The gain on a canceled policy is the difference between the net cash value and loan forgiveness amounts and your policy basis .

**Caution:** You may also be subject to surrender charges. Check your policy.

**Caution:** Policy fees and expenses are usually charged against the policy in the first few years. As a result, policy surrenders during the first few years of the policy may provide little cash value.

**Caution:** If you surrender your policy while there is a loan balance outstanding, you could be subject to income tax on the amount of the loan (plus any accrued but unpaid interest).

### ***Policy lapse may be taxable***

If you allow your policy to lapse, you could be subject to income tax even if you don't receive any cash from the policy. A policy lapse can occur when you stop paying premiums and don't have cash values available that can be used to pay the premiums. If you have an outstanding policy loan, it is possible you could be subject to tax on the amount of the loan plus any accrued but unpaid interest.

### ***Death benefits generally not subject to federal income tax***

Policy death benefits are generally not subject to federal income tax. One notable exception is when the policy has been sold or otherwise transferred for valuable consideration by one policy owner to another, subjecting it to the transfer-for-value rule .

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## **Gift Tax**

### ***Policy proceeds not considered gift to beneficiary***

When the proceeds of your life insurance policy are paid to a beneficiary, they are not treated as a gift for gift tax purposes.

### ***Policy premium payments generally not subject to gift tax***

When you are the owner of a policy on your own life, with another party as the beneficiary, premium payments made by you are not considered a gift to the beneficiary for gift tax purposes. If, however, someone else pays the premiums on a policy you own, the premium payments are considered a gift to you and may be subject to gift tax. However, policy premiums paid by another on your behalf generally qualify for the annual gift tax exclusion .

## **Estate Tax**

### ***Policy proceeds included in estate value in some cases***

The proceeds of a life insurance policy are included in the value of your estate if you held any incidents of ownership at any time during the three years before your death or if the proceeds are payable to you or your estate or executor. Incidents of ownership include (among other things) the right to change the beneficiary, take out policy loans, or surrender the policy for cash.

### ***Policy proceeds often exempt from state inheritance taxes***

In many states, life insurance proceeds are exempt from state inheritance taxes.

## **Questions & Answers**

### ***If you are covered under a group life insurance policy through your employer, do you still need a personal policy?***

Yes, you should have your own policy outside the group coverage provided by your employer. The policy through your current employer is more than likely not portable—meaning that when you leave the company, your life insurance coverage will not go with you. It is very common for people to change jobs numerous times during their career. Even if you plan to stay with your current job until retirement (assuming your job exists that long), what will you have for coverage afterward? The best way to make sure your family is provided for when you die is to have your own insurance coverage in addition to any provided by your employer. While conversion coverage may be available, it may be expensive and it may offer limited coverage. In addition, it may not meet all of your coverage needs.

### ***Can your spouse own a policy on your life and name your child as beneficiary?***

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This can be done, but it shouldn't be. When the insured, the policyowner, and the beneficiary are three different parties (sometimes referred to as the "unholy trinity" or the "Bermuda Triangle"), the death benefit may be subject to gift tax.

***Can you name your spouse as the beneficiary on your life insurance policy if he or she is not a U.S. citizen?***

You can, but there could be estate tax consequences. When your spouse isn't a U.S. citizen and is the beneficiary on your life insurance policy, the death benefit isn't protected by the unlimited marital deduction.

***Should you buy life insurance on your children?***

In some instances it is advisable to buy life insurance on your children, but it shouldn't be done until the appropriate levels of coverage are in place on the lives of the family breadwinner(s) and a non-wage-earning spouse engaged in the care of the children.

***Should you buy term insurance or cash value life insurance?***

It depends upon your personal circumstances. The first issue to resolve is not what type, but how much life insurance you should buy, and how long your coverage is needed. Once you can answer the quantifiable insurance question, you can move on to the financial aspect. It is possible that the amount of coverage you need is so large that the only affordable way to get the coverage is with lower-premium term insurance. If you can afford the needed coverage with either type of policy, then you should think about the financial aspect of which type of policy to buy, considering such factors as your tax bracket and the rate of return you could receive on alternative, similar risk investments.

***With cash value life insurance, does your beneficiary get the death benefit plus the cash value amount?***

Maybe. Check the policy. Many cash value policies are written in such a way that the beneficiary receives only the face amount of the policy at death. The cash value is applied to partially pay off the death benefit. There are policies that will pay the beneficiary the face amount plus the cash value, but the premiums tend to be higher. Don't just assume that your policy will pay both amounts—check the policy and/or ask your agent.

***Should you "invest" in insurance?***

It generally isn't a good idea to buy insurance unless you need it. If you want to invest money, many options are available. When you need insurance, policy types are available that can serve the dual purpose of insurance protection and cash value investments. The bottom line is, don't buy insurance because you are looking for an investment—buy insurance because you need the protection.

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