

How Universal Life Insurance Works

A universal life insurance policy builds account value and provides death benefit coverage. Unlike “whole life” insurance, however, the premiums are not fixed. (*Whole life policies have a fixed premium schedule that must be either paid or borrowed from the policy to keep the coverage in force.*) The premiums of a universal life policy can be increased, decreased, skipped or not paid at all. For a universal life policy, the duration of coverage depends on whether or not the policy has sufficient account value (*i.e., death benefit coverage remains in force as long as the account value is positive*) – not just on the payment of premiums as interest credited (and policy charges) is also a significant factor in driving account value growth.

In simple terms, a universal life policy can be thought of as a bucket with a tap at the top and bottom. Water (*account value*) is created inside the bucket (*policy*) through a top tap with net premium payments and interest on the water (*account value*) already in the bucket (*net premium = premium paid minus the premium load*). With some universal life policies, a dividend or bonus may also be credited and this also adds water to the bucket. Each month mortality (*in insurance terms typically referred to as “Cost of Insurance”*) and administrative charges come out of the bucket (*policy*) through the bottom tap. In addition, the policyholder may choose to take distributions (*withdrawals and/or loans*) from the policy with a resulting dollar for dollar reduction of account value through the bottom tap. The amount of water in the bucket then is simply the accumulation of net premiums paid, less monthly charges, plus monthly interest credits (including bonuses and dividends), and less policyholder directed distributions.



As long as there is sufficient water (*account value*) in the bucket to cover the mortality and administrative charges for a given period, the policy will stay in force. If the account value is ever less than the charges due, the policy enters a grace period and the policy will lapse unless additional premiums are paid.

Universal life insurance is often referred to as “current assumption” universal life since when a universal life policy is first issued, the scheduled premiums are typically determined based on certain illustrated non-guaranteed assumptions:

- Interest rate that will be credited to the account value (*the actual rate will be declared by the insurance carrier based on the performance of the carrier's general account portfolio at time of issue*);
- Mortality and expense charges that will be deducted from the account value (*the actual mortality and expense charges will be based on the insurance carrier's death claim and expense experience at time of issue*);
- Number and timing of premium payments and policy distributions; and,
- Amount of time that the policyholder wants the coverage to stay in force (*e.g. account value remains positive to age 85, to age 95, to age 110, etc.*)

These assumptions are not guaranteed in a current assumption universal life policy. Over time, the crediting interest rate and charges may differ from the original assumptions due to changing carrier experience (*e.g., declining interest rate environment driving lower general account portfolio yield and resulting lower crediting rate*). Therefore, the policyholder must monitor the policy to be assured that their policy will stay in force for the desired coverage period. For example, if the scheduled premiums for a universal life policy were based on an account value crediting rate of 8.0% for coverage to stay in force to the insured's age 100, but if the actual crediting rate has been reduced to 5.0%, the policy will lapse earlier than age 100 unless premiums are adjusted accordingly.

When reviewing in-force policies, new in-force illustrations should be run using the current credited interest rate and charges, and note new illustrated account values and death benefit coverage period. Stress testing with lower crediting rates is also recommended in a declining interest rate environment.

How Universal Life Insurance Works

Frequently Asked Questions

What options does the policyholder have if the policy illustrated death benefit coverage will not stay in force as long as expected in a universal life policy?

If a scheduled premium is not paid or reduced, if the account value interest rate drops, or if the mortality and expense charges increase, the water (*account value*) in the bucket will drop and the policy may lapse earlier than expected. The policy owner has several options:

- Pay more premium than originally planned (*note additional premium needed will increase with delayed payment due to lost interest compounding*)
 - Pay a lump sum make-up premium.
 - Pay original premium for a longer period than originally planned.
 - Pay a higher ongoing premium than originally scheduled.
- Reduce the size of the bucket (*i.e., reduce the face amount of the policy*). This will have the effect of increasing the water-level in the bucket as the mortality charge is reduced.
- Wait and see if the account value rate increases or if the mortality and expense charges decrease within the next few years and then take action to get the policy back on track (*again note delayed action may only increase cost*).
- Review market for potentially better performing products and transfer to a new policy via 1035 exchange with no tax consequences (*basis is carried over to the new contract*). 1035 exchanges will require new underwriting.
- Do nothing and allow the policy to lapse early.

What options are available if a Universal Life policy builds “excess” account value (i.e. there is more than enough account value to keep the policy illustration in force until the desired age)?

In some cases, policyholders prefer to build excess account value. In fact, they may reduce the face amount of the policy, pay additional premiums or increase the amount of their premiums in order to build excess account value. There are various reasons for using this strategy:

- To accumulate account values on a tax-deferred basis in order to provide cash distribution living benefits (*account value withdrawals and/or loans*) for purposes such as retirement income or educational funding.
- To add account value “cushion” to the policy in case future policy performance deteriorates.
- To increase the death benefit without providing evidence of insurability since, as the account value approaches the policy’s face amount, the death benefit increases to satisfy the Definition of Life Insurance.

If, on the other hand, the policyholder only wants death benefit protection, the following options are available:

- Discontinue or reduce the premium payments.
- Reduce the premium-paying period.
- Increase the policy face amount. (*Increases are subject to evidence of insurability.*)

Note: The policy owner can also withdraw or borrow the excess cash value; however, the policy’s death benefit and account value will decrease by the amount of the withdrawal or loan.

How is the declared account value crediting rate determined for Universal Life?

Most UL products use the portfolio method, where the insurance companies take the net premium payments they receive from policy owners and purchase interest bearing financial instruments, usually high quality corporate bonds and mortgages with a 5- to 10-year duration. These bonds and mortgages are mixed into a common portfolio (*i.e., the general account*) with

How Universal Life Insurance Works

bonds and mortgages purchased with net premium payments from other policy owners. The earnings rate from the entire portfolio, after deduction for expenses and profit margin, is the basis for interest credits on policy account values.

The insurance company general account portfolio at any given time will typically be comprised of bonds and mortgages purchased over the last 5 to 10 years. In a declining interest rate environment, older purchases will be generating higher interest income than more recent purchases, and the portfolio earnings rate will be higher than earnings rates available in the current marketplace (*the new money rate*). As older purchases mature, new bonds and mortgages earning the lower new money rate will be purchased with the proceeds (*portfolio turnover*). Through portfolio turnover and new premium dollars, the portfolio earnings rate will move slowly towards the new money rate.

The speed at which an insurance company general account portfolio earnings rate moves in the direction of a different new money rate is a function of how much turnover is taking place within the portfolio, and the size of new premiums relative to the portfolio as a whole. As a result, any given insurance company may change its interest credit rates quicker or slower than any other given company, but the movement towards new money rates will exist for all companies.

Policy illustrations are necessarily based on an assumption as to what rate of interest will be credited in the future. Current crediting rates are based on current carrier general account portfolio earnings but it is impossible to know now what interest rates will actually be earned and credited in the future, so policy illustrations should be considered only as an example of what might happen, not a prediction of what will happen. Therefore, illustrations based on various interest credit assumptions should be evaluated (*e.g., illustrate lower crediting rates in a declining new money interest rate environment*).

How are distributions (withdrawals, loans, etc.) from a Universal Life policy treated?

Distributions from life insurance policies prior to the death of the insured may be subject to income taxation depending on the type of distribution (*e.g., withdrawal, surrender, loan, dividend*), the life insurance policy duration at the time of distribution and effective tax law at that time. These distributions typically also reduce policy account values and death benefits. Withdrawals and other distributions from non-Modified Endowment Contract (*non-MEC*) policies in the first 15 years may be taxable to the extent they occur in conjunction with (*or during the two years immediately prior to*) a reduction in benefits. After 15 years, withdrawals and other distributions up to the life insurance policy cost basis are not taxable. Life insurance policy loans are not taxable for a non-MEC policy provided that it remains in force until the death(s) of the insured(s). Withdrawals, policy loans and other distributions from a MEC policy are subject to other rules and are generally taxable as "income first". If prior to the death(s) of the insured(s) the policy (*MEC or non-MEC*) is surrendered or lapses with an outstanding policy loan balance, the policyowner will be subject to income taxes to the extent the account surrender value plus the amount of the outstanding loans exceeds the policy cost basis. Withdrawals, policy loans, and other distributions will reduce policy values and typically reduce the death benefit dollar for dollar.

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For federal income tax purposes, life insurance death benefits generally pay income tax-free to beneficiaries pursuant to IRC Sec. 101(a)(1). In certain situations, however, life insurance death benefits may be partially or wholly taxable. Situations include, but are not limited to: the transfer of a life insurance policy for valuable consideration unless the transfer qualifies for an exception under IRC Sec. 101(a)(2) (i.e., the transfer-for-value rule); arrangements that lack an insurable interest based on state law; and an employer-owned policy unless the policy qualifies for an exception under IRC Sec. 101(j).

Tax-free policy distributions assume, among other things: (1) withdrawals do not exceed tax basis (generally, premiums paid less prior withdrawals); (2) policy remains in force until death; (3) withdrawals taken during the first 15 policy years do not occur at the time of, or during the two years prior to, any reduction in benefits; and (4) the policy does not become a modified endowment contract. See IRC §§ 7702(f)(7)(B), 7702A. Any policy withdrawals, loans and loan interest will reduce policy values and may reduce benefits.