VARIABLE UNIVERSAL LIFE INSURANCE

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Variable Universal Life Policies Fluctuate in Value

- Variable universal life (VUL) provides insurance protection combined with professionally managed investments.
- A VUL policy can provide a number of tax-advantaged opportunities, including:
  - **Income tax-free death benefits.** The death benefit paid to beneficiaries is income tax free, and—when properly structured—can be excluded from the policyowner's taxable estate.
  - **Tax-deferred accumulation.** Earnings in the policy accumulate on a tax-deferred basis until withdrawn. Because cash values are not subject to current taxation, they may increase faster.
  - **Nontaxable transfers.** VUL policies offer a choice of investment options. Generally, as needs change, the policyowner can make transfers between investment options at no additional charge and without tax consequences.
  - **Tax-free access to cash.** A policyowner can take policy loans and partial withdrawals without incurring income taxes. In some cases, the ability to access lower-interest-rate loans lets a policyowner respond to financial demands as needs arise.
- As the policyowner's personal situation changes (e.g., marriage, birth of a child or job promotion), so will the need for life insurance protection.
- The policyowner should carefully consider whether VUL products are suitable for long-term life insurance needs by weighing objectives, time horizon, risk tolerance and associated costs.
- Market volatility can lead to the need for additional premium to keep the policy in force. In addition, variable life insurance has fees and charges that include cost of insurance (based on the insured's gender, health and age), underlying fund costs, expenses and additional charges for customizing a policy to fit individual needs. Of course, all guarantees are subject to the claims-paying ability of the issuing insurance company.

The Concept

- With variable universal life, policyowners have access to a separate account where they can select variable investment options with the potential for greater earnings than guaranteed rates can provide.

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- However, along with the chance for greater earnings comes risk—the risk of earnings that are lower than those found in traditional whole life insurance contracts with guaranteed interest rates.
- A VUL policy also lets the policyowner adjust both the premium payments and the death benefit.

The Contract

- A variable universal life insurance contract provides a great deal of flexibility not found in traditional life insurance policies.
- The policyowner may increase or decrease premium payments—or skip them entirely in some cases—as finances and priorities change.
- The policyowner may also increase or decrease the death benefit.
- Variable cash values can grow with favorable investment performance.
- The policyowner has control over a selection of variable investment options within the contract.
- The policyowner can choose from a range of options for loans and withdrawals.
- As with all types of cash value life insurance, poor policy performance, distributions (through loans or withdrawals), and underfunding can cause the policy to lapse. The policyholder has the added responsibility of managing the policy accordingly.

Other Characteristics

- The death benefit guarantee and the guarantee associated with the fixed interest account are based on the claims-paying ability of the issuing insurance company; they do not extend to the separate investment account.
- Variable universal life contracts are not deposits or other obligations, are not guaranteed by a bank or credit union, and are not insured by the FDIC, the NCUA or any other federal entity.
- The policyowner has access to available cash values to supplement retirement income, fund educational needs or meet other financial needs.
- A variable universal life insurance contract enjoys the same tax advantages as traditional life insurance policies.

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Potential Disadvantages

- Earnings are not guaranteed and are subject to market and investment risk. Variable universal life contracts may lose value, including the possible loss of the principal amount.
- The policyowner assumes the risk inherent in selecting among the variable investment options specified in the policy. While equities have historically produced reasonable returns over time, past performance is no guarantee of future results.
- A variable universal life contract could terminate if the surrender value becomes too low to support the monthly charges due on the policy. If the policy terminates and is not reinstated, the policy will have no accumulation value, surrender value or death benefit.

The Investment Options

- Variable universal life investment accounts are held in separate accounts, segregated from the insurer's general accounts.
- Investment options available to the policyowner include money markets, stocks, bonds, government securities and other specialized investments.
- A policyowner can select among the variable investment options and/or reallocate funds according to changes in the economy or personal circumstances.
- For policyowners concerned about losses, many insurers offer a fixed account with a guaranteed rate of interest. The insurer assumes the risk for investments in a fixed account, just as if the policy were a traditional whole life policy—however, the return may be lower over the long run than might be expected from other variable investment choices.
- Some insurers offer guaranteed death benefits upon payment of specified premium amounts.

The Premium

- Premium payments are flexible in a variable universal life policy. Within specified policy limits, the policyowner may increase or decrease the premium payment—or skip it altogether—as personal finances and priorities change.
- A decrease in premium (or skipped premium) is only possible after the policy has built enough cash value in the variable investment options to keep the policy in force.

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- While reducing or skipping a premium also reduces the cash value, a policyowner who is experiencing a financial hardship may welcome this flexibility.
- Typically, there is no limit on the number of times—or the amounts—by which the policyowner may change the premium as long as there is enough cash value to keep the policy in force.
- Paying smaller premiums—or skipping premiums—requires the policyowner's careful attention, since it can deplete the cash value to a point where the policy is in danger of lapsing. The insurance company is required to notify the policyowner if this occurs and advise the minimum premium required to keep the insurance protection in force.
- The only limit on increasing a premium is that, to retain the tax-favored status life insurance enjoys, there must always be a certain amount of "pure insurance" protection not attributable to the cash value element.

The Death Benefit

- The VUL death benefit is both adjustable and variable.
- A policyowner who decides that the original amount of insurance isn't enough may increase the death benefit with the insurance company's approval—a decision partly based on the continued insurability of the insured.

The Options

- When a variable universal life policy is first put into effect, the policyowner generally chooses between a level death benefit and an increasing death benefit (although some policies offer more options).
- Option A (or Option 1) is a level death benefit equal to the face amount of the policy, with the cash value as part of the benefit instead of a separate, additional amount. This is identical to the death benefit in a traditional whole life policy.
- With Option A, the policyowner can still request to increase or reduce the death benefit. But since the required pure insurance protection must be maintained for the policy to retain its tax-favored status, the insurance amount might have to be increased if the cash value approaches the face amount.
- Option B (or Option 2) offers an increasing death benefit consisting of the policy's face amount plus the accumulated cash value.

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- With Option B, the pure insurance amount remains the same throughout the life of the policy. The growing cash value is what accounts for the increasing death benefit.
- Thus, the exact death benefit with Option B isn't known until the insured dies and the accumulated cash value is added to the face amount.
- Option B requires a higher premium since the pure insurance protection is never reduced by the increasing cash value, as it is with Option A.

Changing Options

- Over the life of a variable universal life policy, the policyowner can request a change from the originally selected death benefit option.
- Changing from Option A to Option B may require proof of the insured's continued insurability, since it involves a greater amount of pure insurance, and therefore a greater risk for the insurance company.
- Changing from Option B to Option A has no such requirement because, like conventional permanent insurance, the pure insurance amount decreases as the cash value increases, combining to equal the policy's face amount.

Fees and Expenses

- Policyowners periodically receive a statement showing the various charges assessed in a variable universal life policy, as well as the value of the variable investment options.
- The charges, which are deducted from the policy's cash value, include a monthly premium expense charge and a monthly charge to pay for the pure insurance protection under the policy.
- A surrender charge is usually assessed if the owner terminates the policy or withdraws funds. The charge is usually higher in the policy's early years, gradually decreasing the longer the policy stays in force.
- Additional fees and expenses associated with variable universal life contracts include investment management fees, mortality and expense risk charges, annual administrative costs, and any other charges assessed for optional benefits or features.

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Loans and Withdrawals

- The owner of a VUL policy can access cash values through loans and withdrawals.
- The borrower pays interest on a loan, often at a lower rate than interest rates for a conventional loan.
- The policy's death benefit and cash value are reduced by the amount of the loan.
- The policyowner may also be permitted to take partial withdrawals of the cash value.
- The owner pays no interest, but there may be a withdrawal charge in addition to ordinary income tax to the extent the withdrawal exceeds the investment in the contract.
- The policy's death benefit and cash value are reduced by the amount of the withdrawal.

Before Making a Purchase

- Variable life insurance policies—including variable universal life—are sold by prospectus.
- Before purchasing a variable universal life contract, investors should carefully consider the investment objectives, risks, charges and expenses, and the contract's underlying investment choices.
- For this and other information, the buyer should obtain the prospectus from a registered representative and read it carefully before investing or sending money.
- The individual that markets a variable universal policy must be registered with FINRA and hold a valid securities license and a life insurance license under applicable state laws.

The Bottom Line

The appeal of variable universal life insurance lies in its flexibility and its potential to generate investment earnings in excess of the policy's guarantees. The policyowner isn't locked into unchangeable premiums, death benefits or investment options, but is free to make adjustments based on changing needs, circumstances and investment objectives.

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