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Types of Life Insurance

Life insurance comes in several different flavors, so learning the options and then selecting the right type of policy for your goals and budget is crucial.

In general, life insurance is a contract between a policy owner and an insurer, whereby the insurer promises to pay a designated beneficiary a sum of money, called a "death benefit," upon the passing of the insured person, in exchange for a premium, paid in a lump sum or over time.

Under current tax law, death benefits are exempt from Federal income and capital gains tax; with additional planning, they can be exempt from Federal estate tax, too.[1]

TERM LIFE

Term life insurance is designed to last for a specific amount of time or "term," which can range from 1-to-40 years. Term life is pure coverage without a cash value component.

Premiums are inflexible but they are guaranteed not to increase for the length of the term. At the end of the term, a new policy and updated medical underwriting is typically required.

Some term policies offer a feature that allows conversion to a permanent policy of the same or smaller amount within a certain period and without evidence of insurability. This can be valuable if the policy owner wants to extend coverage beyond the term, but the insured cannot medically qualify.

PERMANENT LIFE

As opposed to term, permanent life insurance is designed to last until the insured's death, whenever it may occur. It combines term insurance death benefit protection with a cash value account that grows tax-deferred. Each year, the life insurer deducts what it needs from the premium to cover mortality and administrative costs; the rest goes into the cash value account. The owner can access the cash value during the insured's lifetime for different purposes, including reducing premiums, pledging it as collateral for a loan, receiving in cash, or leaving it to accumulate.

There are five main types of permanent life insurance policies, discussed in detail, below. Many of the differences come down to the option chosen as the mechanism that drives the growth of the cash value account.

WHOLE LIFE

Like all permanent life insurance policies, whole life provides lifelong coverage and includes a cash value component. Although it's more complicated than term, whole life is the most straightforward form of permanent life insurance. This is because the premium is designed to remain the same for as long as the insured lives, the death benefit is guaranteed, and the cash value account grows at a guaranteed rate.

Most whole life policies can also earn annual dividends on cash value, which represents a portion of the insurer's financial surplus, but they are not guaranteed.

Whole life premiums are not as flexible as other types of permanent insurance, and policy loan interest rates can be high.

Whole life is most appropriate for those with a conservative risk profile.

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UNIVERSAL LIFE

Universal life (UL) insurance has a cash value account that grows at a guaranteed crediting rate as well as a current crediting rate, which is usually higher. Premium projections are based on the current crediting rate, so if the rate goes down, premiums could go up, and vice versa.

UL is the "chassis" that many other types of permanent life insurance are built upon.

GUARANTEED UNIVERSAL LIFE

Guaranteed universal life (GUL) insurance takes the concept of UL but removes the interest rate risk aspect. Premiums stay the same, regardless of interest rates, and policies have a "no-lapse" guarantee, meaning that coverage will continue as long as the premiums are paid. This also means, however, that GUL policies are not very flexible because they typically have little to no cash value, leaving nothing to support the death benefit if premiums are not paid. In that way, GUL most closely resembles term life insurance and is sometimes referred to as "permanent term."

GUL is for people who want basic coverage later in life, beyond the length of term policies.

INDEX UNIVERSAL LIFE

With index universal life (IUL) insurance, the cash value growth is tied to the performance of a market index, like the S&P 500.

Unlike investing directly in an index fund, however, the policy won't lose money when the market has a downturn. This is because a guarantee or "floor" applies to the rate, insuring it against losses.

On the other hand, there's usually a "cap" on the maximum return that the policy can earn. Indeed, one of its most attractive features is the ability to take advantage of stock market-like returns without the risk of loss, while building up a death benefit that the beneficiaries will receive tax-free. Most IUL policies allow the owner to divide cash value assets between fixed and indexed portions of the policy.

VARIABLE UNIVERSAL LIFE

Variable universal life (VUL) insurance uses separately managed accounts, referred to as sub-accounts, to grow the cash value. Subaccounts are structured like mutual funds with various stock and bond options. The cash value assets are held by the sub-account investment managers, who deduct their own fees, rather than by the insurance company.

By separating the savings component from the death benefit component, the life insurer transfers all the investment risk of the policy. The policy owner must assume the possibility that the separate account may generate negative returns, which will reduce the cash value and may result in higher premium payments.

Because the sub-accounts are securities, the life insurance representative must be a licensed producer and registered with FINRA.

Other Benefits of Life Insurance

In addition to the death benefit protection, the cash value component of permanent life insurance has other benefits and special tax advantages that should be considered, especially for retirement planning needs, including:

Unlimited contributions

Traditional retirement plans have contribution limits, but permanent life insurance policies don't.

Tax-free growth and distributions

Distributions are tax-free versus tax-deferred in the other vehicles. That means no taxes are due on the money drawn from the cash value, making it like a Roth IRA in this respect.

Access at any time

With regular retirement programs, you must wait until you reach age 59½ before you can start taking money out. With a permanent life policy, there is no age requirement.

Loan availability

Depending on the policy and available cash value, money can be borrowed without facing penalties, taxes, or a credit check. Plus, the funds do not have to paid back.

Summary

With so many different policy options and carriers to choose form, it can be challenging to navigate the life insurance marketplace alone. Working with an independent life insurance professional is critical and knowing the basics will help ensure you make the most informed decision.

Please contact our office if we can assist you

www.acumeninsurancesolutions.com

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1. Tax-free death benefit IRC §101(a) and tax-deferral of cash value IRC §7702 (a), (g). Policy performance is based on current rates as charges, and values are not guaranteed. Medical and financial underwriting is required. Withdrawals and loans from life insurance policies classified as Modified Endowment Contracts (MEC) may be subject to income tax and a federal tax penalty, if taken prior to age 59½. Policy withdrawals and loans may cause the policy to lapse, which will result in the loss of death benefit and adverse tax consequences. Life insurance is backed by the claims paying ability of the carrier and is not FDIC insured. See policy illustration for details. Acumen Insurance Solutions does not provide tax, legal, or investment advice, and is not FINRA registered.