

## Variable Life Insurance

Variable life insurance is similar to whole life in that the premium payments are level, and there is generally a minimum guaranteed death benefit. Unlike whole life policies, however, variable life insurance permits the policyowner to allocate a portion of each premium payment to one or more investment options, in separate subaccounts, after a deduction for expense and mortality charges.

The death benefit and cash value of a variable life policy will increase or decrease based on the performance of the investment options chosen. The death benefit, however, will not drop below an initially guaranteed amount, unless policy premiums are not paid or if loans or other withdrawals are taken from the policy. The ultimate death benefit is subject to the claims paying ability of the insurer.

Because the investment options available inside a variable life policy usually involve securities (e.g., stocks and bonds), the Securities and Exchange Commission (SEC) requires this type of policy to be accompanied by a prospectus. The prospectus provides detailed information on how the policy works, its risks, and all expenses or charges involved. The SEC also requires individuals selling variable life policies to be licensed to sell securities.

### Policy Variations

There are two primary variations of variable life insurance, based on the formula used to link the amount of death benefit to the performance of the investments chosen by the policyowner. In general, if investment performance is positive, the amount of the death benefit increases; if investment performance is negative, the death benefit amount will decrease.

- **Corridor percentage:** Under this method, also known as the constant ratio method, the amount of the death benefit is periodically changed to equal a certain percentage of the cash value. Under current tax law, this percentage is 250% up to the insured's age 40, gradually decreasing to 100%, usually at age 95.
- **Level additions:** Also known as the net single premium approach, this method uses excess investment earnings to purchase an additional amount of single premium, paid-up insurance.

## Common Uses of Variable Life

Variable life policies are well suited for use by policyowners who are comfortable with the risks and rewards of investments, and who need life insurance with the potential to provide an increasing death benefit. Some common uses are:

- **Supplement existing family protection:** Acts as a supplement to an existing, basic life insurance plan. If the market is down when an insured dies, the variable death benefit of a variable life policy may not provide adequate funds to support a surviving spouse and/or minor children, or to pay final estate expenses.
- **Business planning:** Variable life insurance is often used for many different business purposes, such as insuring key employees, in split-dollar insurance arrangements, and funding nonqualified deferred compensation plans. Business continuation planning often involves variable life insurance as a source of funds of buy-sell agreements.
- **Accumulation needs:** Some individuals will use the cash value feature of variable life as means of accumulating funds for specific purposes, such as funding college education, or as a supplemental source of retirement income.
- **Charitable gifts:** To provide funds for a gift to charity.

## Modified Endowment Contracts (MECs)

A life insurance policy issued on or after June 21, 1988 may be classified as a modified endowment contract (MEC) if the cumulative premiums paid during the first seven years (7-pay test) at any time exceed the total of the net level premiums for the same period.<sup>1</sup> If a policy is classified as a MEC, all withdrawals (including loans) will be taxed as current income, until all of the policy earnings have been taxed. There is an additional 10% penalty tax if the owner is under age 59 ½ at the time of withdrawal, unless the payments are due to disability or are annuity type payments.

A variable life policy can avoid treatment as a MEC through a well-designed premium payment schedule.

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<sup>1</sup> Including a policy issued before that date, but later materially changed.

## Additional Policy Elements

Variable life policies have a number of additional elements to consider:

- **Investment options:** Most variable life policies offer a policyowner a wide range of investment options, including basic stock, bond and money market funds. Depending on the policy and insurer, other options, such as index funds, real estate funds, foreign stock funds, or zero-coupon bond funds may also be offered. A policy may also include a fixed account option, in which the insurer guarantees a fixed rate of return.
- **Portfolio changes:** Many variable life policies allow a policyowner to change their investment allocation at least once per year (sometimes more frequently), usually at no charge.
- **Policy loans:** Almost all variable life policies typically permit the policy owner to borrow at interest a portion of the accumulated cash value, with the insurance company charging interest on the loan. The rate charged on the borrowed funds is often lower than current open market rates. A policy loan will reduce the death benefit payable if the insured dies before the loan is repaid; a policy loan will also reduce the cash surrender value if a policy is terminated. If the policy lapses or is surrendered with a loan outstanding, the loan will be treated as taxable income in the current year, to the extent of gain in the policy.
- **Partial withdrawals:** Most variable life policies allow a policy owner to withdraw a portion of the cash value, without terminating the policy. Such withdrawals reduce the amount of death benefit payable, and may be subject to current income tax, if the policy is classified as a MEC, or if the withdrawal exceeds cost basis for a non-MEC policy.
- **Policy dividends:** Variable life policies classified as participating offer the possibility of policy dividends. Dividends from a participating variable life policy are not guaranteed, and represent a return to the policyowner of a portion of the premium paid. Most participating policies offer a number of options as to how the dividends may be used.
- **Surrender charges:** Most variable life policies have substantial surrender charges, if a policy is terminated. These surrender charges are generally highest in the early years of a policy, and decline over a period of time, usually from seven to 15 years.
- **Surrender options:** If a policy owner surrenders a policy, there are generally three ways in which the accumulated cash value may be received, including: (1) taking the accumulated cash value, less any surrender charges; (2) received a reduced amount of paid-up insurance; or (3) taking paid-up term insurance in an amount equal to the original face amount of the policy.

## Optional Policy Provisions

A number of optional policy provisions, commonly referred to as riders, can be added to a variable life policy, generally through payment of an additional premium. Not all riders are available from all insurance companies.

- **Waiver of premium:** Waives the payment of policy premiums if the insured becomes disabled and is unable to work.
- **Accidental death:** Pays the beneficiaries double (in some situations triple) the face amount of the policy if the insured dies in an accident.
- **Spousal or family term insurance:** Allows a policy owner to purchase term insurance on a spouse or children.
- **Accelerated death benefits:** An accelerated death benefits provision allows for payment of part of a policy's death benefit while an insured is still alive. Such benefits are typically payable when the insured develops a medical condition expected to lead to death within a short period of time.

Variable life insurance policies are primarily intended to meet long-term insurance needs. Your Jacobi Capital team is available to explain the nuances of a policy, or help you choose the policy that's appropriate for your needs and long-term goals.

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