KYLE Financial & Insurance SOLUTIONS

No Lapse Guarantee and Current Assumption Universal Life Products

Overview

No Lapse Guarantee Universal Life and Current Assumption Universal Life products both offer life insurance protection for a variety of family wealth and business planning needs. But it is essential to understand the significant differences between these two types of life insurance products when choosing one over the other to assure that the purchaser's needs for life insurance are intelligently met. And it is just as essential when selecting a product to understand that the purchase of a life insurance policy is typically insuring a need that may span several decades before the insured's death and may evolve significantly over that span of time.

Overview of Product Features

In a nut shell, one of the key differences between the two types of products is the impact that interest rates have on the performance of the products. With Current Assumption Universal Life (CAUL) products, the premiums required to keep the policy in force over the lifetime of the insured may vary from the premium amounts originally illustrated when the policy was purchased. If interest rates decline after the purchase of a CAUL policy, additional premiums than those originally illustrated may be required to keep the policy in force and avoid the risk of lapsing. In contrast, with a No Lapse Guarantee (NLG) policy the insurance carrier guarantees that irrespective of interest rate movements, as long as the policy holder pays the originally illustrated premiums in accordance with the terms of the contract, the policy will not lapse.

Conversely, if interest rates were to rise after the purchase of a policy, CAUL products would offer the consumer a variety of options more fully discussed below (including the option of paying less premiums than the amounts originally illustrated to keep the policy in force). With an NLG product, rising interest rates would not reduce the amount of premiums required to keep the policy in force and would not offer the consumer any option but to keep paying the originally illustrated premiums in accordance with the terms of the contract to keep the policy in force.

Tax Implications

Recent trends and developments with interest rates and our federal tax laws may alter the landscape as to which product type consumers will be choosing.

Interest Rates

NLG policies came into prominence in the mid 2000's at a time when interest rates were extremely volatile. For example, from 2004 to 2006, the average interest rate on a 6-month certificate of deposit rose from 1.74% to 5.24% and declined to 0.87% by 2009. During that same period, the rates on a 1-year US Treasury security spiked from 1.89% to 4.94%, before landing at 0.47% in 2009.[1] Given the roller coaster ride consumers were experiencing with the interest rate market, NLG policies provided consumers a life insurance product for meeting their life insurance needs that guaranteed[2] to insulate their life insurance premium outlays from the volatility of interest rates, and those guarantees materially impacted consumer behavior.

But despite the relative lack of any significant interest rate movements during the last six years, the historically low interest rates during that period and double-digit percentage increases in NLG premiums by a number of carriers active in the NLG market, large numbers of consumers purchasing universal life insurance continue to purchase NLG policies. Obviously, no one can predict when and if interest rates will rise, but individuals purchasing NLG policies in today's low interest rate environment will miss out on the opportunity to potentially lower their premium costs if interest rates rise during the life of the insured.

In contrast, the amount of premium required to maintain a CAUL policy in force is subject to fluctuations in market interest rates. Purchasers of CAUL policies in today's low interest rate environment may have opportunities to potentially lower their premium outlays or keep paying the originally illustrated premiums and potentially experience cash value growth in the policy if interest rates rise during the life of the insured. And the build-up of cash values within a life insurance policy offers policy holders additional options that will not be available to owners of NLG policies (as discussed further below) if their needs for insurance coverage change or evolve over the life of the insured.

Federal Tax Laws

Recent federal tax laws and other legislation may soon become a growing factor for consumers choosing between an NLG and CAUL product. During the last decade—and prior to the passage of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the "2010 Tax Act")—individuals purchasing life insurance to fund potential federal estate tax liabilities were facing a large degree of uncertainty due to the nature of the estate tax laws at that time. Prior to the passage of the 2010 Tax Act, from 2001 through 2010 the estate tax was scheduled to materially decrease over that period and to be repealed for one year during 2010.

After 2010, the federal estate tax was scheduled to return with full force and effect in 2011 with an estate tax exemption of $1 million and an estate tax rate as high as 55% for estates worth $3 million or more. During that same period, the lifetime gift tax exemption amount was limited to $1 million.

As a result, the strategy for purchasing life insurance for estate tax funding purposes that took hold in the planning community for high net worth individuals and families was to maximize and leverage the amount of death benefit that each premium dollar could purchase using the relatively modest gift tax exemption amount of $1 million. Little regard was given to various other features of permanent life insurance, such as cash value growth, on the premise that the death benefit to be received upon the death of the insured when an estate

[1] Source: www.federalreserve.gov
[2] Guarantees are based on the claims paying ability of the issuing company.

tax would be due was all that was required from their life insurance coverage to meet the family's estate tax funding needs.

With the passage of the 2010 Tax Act and the American Taxpayer Relief Act of 2012 (the "2012 Tax Act"), the federal estate tax exemption amount and lifetime gift tax exemption amount were increased to $5 million (as indexed for inflation beginning in 2011). And it has become apparent to a number of individuals who purchased NLG policies for estate tax funding purposes based on the laws in effect before 2011, that the face amount of their policies may now exceed their estate tax exposure under current law.

Under most existing NLG policies, the policy owner might have the option of reducing the face amount of the policy as long as the NLG premium for the reduced face amount policy continues to be paid as required under the contract or surrender the policy if the coverage is no longer required. But if history is any indication of the nature of our tax laws, lowering the face amount of an existing NLG policy or surrendering the policy might not be the wisest move given the frequency with which our estate tax laws have been changed over the last several decades. Moreover, with many NLG policies, a surrender would not return much value to the policy owner and result in significant loss of premiums paid. If the federal estate tax laws were to change again and estate tax rates were to increase and/or exemption amounts were to be reduced, lowering the face amount or dropping the coverage of an existing NLG policy today might later prove to be a financially short-sighted decision.

By contrast, purchasers of CAUL policies (with their potential for cash value growth when funded accordingly) have additional flexibility to deal with the uncertain nature of our federal estate tax laws that purchasers of NLG policies do not. Owners of CAUL policies who purchased policies for estate tax funding purposes prior to the 2010 Tax Act with face amounts in excess of their estate tax exposure under current law have the option of reducing the face amount of their policy (as do holders of NLG policies as discussed above).

But unlike holders of NLG policies, owners of CAUL policies that have sufficient cash values have the additional options of continuing to pay the originally illustrated premiums to keep the policy in force at the original face amount, or scaling back on the amount or frequency of the premiums paid into the policy while they continue to monitor future developments in our federal estate tax laws. Additionally, if an owner of a CAUL policy does lower the face amount of their existing policy and additional coverage is needed at some future date because of a change in our estate tax laws, the owner of a CAUL policy may have the option of using the cash value of their existing policy to exchange it for a new policy with the larger face amount (assuming the insured remains insurable).

Insights

NLG products have been subject to certain reserve requirements under NAIC Actuarial Guideline 38 (AG 38) since 2003. Many NLG issuers were able to bypass some of the reserving and other requirements of AG 38 by reinsuring their NLG business through offshore captive subsidiaries. On December 16, 2014, the NAIC adopted Actuarial Guideline 48 (AG 48), which applies to most NLG policies issued after January 1, 2015. AG 48 closes many of the loopholes found in AG 38 by generally requiring the same level of reserving regardless have exited the marketplace, while others who previously relied on offshore captives to bypass AG 38 have had to re-price their NLG products sold as of 2015.

Ordinary income generated within an irrevocable non-grantor trust that is not distributed to the trust's beneficiaries is subject to the highest federal marginal income tax rate of 39.6% if the trust has taxable income in excess of $12,300 in 2015 (as indexed for inflation). If the income is considered "net investment income" under Internal Revenue Code (the "Code") § 1411, the trust's undistributed ordinary income above $12,300 will be subject to an additional 3.8% net investment income tax (known also as the "Medicare surtax"), for a

combined rate of 43.4%, significantly reducing the trust's after-tax return on its investments. Moreover, long term capital gains realized and qualified dividends received by such a trust will be taxed at a 20% capital gains tax rate and also be subject to the Medicare surtax for a combined tax rate of 23.8%.

Given the potential higher income taxes trusts may be faced with on returns from their investments and other financial products, paying additional premiums into a CAUL policy to maximize cash value growth may provide significant advantages for trusts looking to minimize their income tax exposure. First, any cash value growth within a CAUL policy is taxed on a deferred basis. And if the beneficiaries of the trust ever need access to cash during the life of the insured, the trustee can (if authorized under the terms of the trust) withdraw cash values from the CAUL policy income tax free to the extent of the trust's tax basis in the policy. Additional cash values to the extent available can also be accessed income tax free through loans against the policy as long as the policy remains in force until the insured's death and does not lapse with policy loans outstanding. Note that withdrawals and loans will reduce the policy's cash value and death benefit.

If the trust is a grantor trust, a CAUL policy that is funded not to become a modified endowment contract (as defined in the Code) will offer the grantor similar income tax advantages. That is, if the trustee needs to access the policy's cash values (either through withdrawals or policy loans[3]), doing so for the benefit of the beneficiaries will not expose the grantor to additional income tax or net investment income tax.

Caveats

Given the uncertainty over the future of our federal estate tax laws, owners of existing NLG and CAUL policies should not take any action to change their coverage amounts without first consulting with their life insurance professional and other professional advisors. Individuals who are currently considering the purchase of a new NLG or CAUL policy to fund a future estate tax liability should also consult with their life insurance professional to evaluate the relative benefits of the guarantees and risks provided by NLG policies in today's low interest rate environment and the flexibility provided by CAUL policies if interest rates were to rise or estate tax laws were to change during the life of the insured.

[3] Policy Loans accrue interest and, along with withdrawals, decrease the death benefit and cash surrender value.

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