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Understanding Life Insurance Options

A comprehensive guide to term, whole life, universal, and indexed universal life insurance — and how to determine the right coverage for your needs.

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Chapter 1: Beyond the Death Benefit

Life insurance is one of the most misunderstood financial tools available. Many people think of it solely as a death benefit — a payout to your family when you pass away. While the death benefit is the foundation, modern life insurance products offer living benefits that can play a significant role in retirement planning, tax management, estate preservation, and wealth transfer.

The life insurance industry has evolved dramatically over the past several decades. Today, you can choose from a range of products — from simple, affordable term coverage to sophisticated permanent policies that accumulate cash value, provide tax-advantaged income, and protect against market downturns.

Why Life Insurance Matters

- **Income Replacement:** Replace lost income for dependents if the primary earner passes away.
- **Debt Coverage:** Pay off a mortgage, car loans, student loans, and other debts.
- **Education Funding:** Ensure children can attend college even without a parent.
- **Estate Liquidity:** Provide cash to pay estate taxes, legal fees, and final expenses without forced asset sales.
- **Business Continuity:** Fund buy-sell agreements, key person coverage, and business succession plans.

- Legacy Planning: Leave a tax-free inheritance to heirs or charitable organizations.
- Living Benefits: Access cash value for retirement income, emergencies, or long-term care needs.

Key Concept: Life insurance is not one-size-fits-all. The right policy depends on your age, health, income, family situation, financial goals, and time horizon. This guide will help you understand each type so you can make an informed decision with your advisor.

In the sections that follow, we will examine four primary types of life insurance: Term Life, Whole Life, Universal Life, and Indexed Universal Life. Each has distinct characteristics, advantages, and trade-offs that make it suitable for different situations and goals.

Chapter 2: Term Life Insurance

Term life insurance is the simplest and most affordable form of life insurance. It provides a death benefit for a specific period (the "term") and has no cash value component. If you pass away during the term, your beneficiaries receive the death benefit. If you outlive the term, coverage ends (unless renewed or converted).

How Term Life Works

1. You choose a coverage amount (e.g., \$500,000) and a term length (e.g., 20 years).
2. You pay a level (fixed) premium for the duration of the term.
3. If you die during the term, your beneficiaries receive the full death benefit, income tax-free.
4. At the end of the term, you can typically renew at a much higher rate, convert to a permanent policy, or let the coverage lapse.

Common Term Lengths

Term Length	Best For	Typical Use Case
10 Years	Short-term needs	Covering a specific debt, business loan, or short obligation
15 Years	Medium-term needs	Covering remaining mortgage, children in school
20 Years	Most common choice	Income replacement until kids are independent, mortgage payoff
30 Years	Longest standard term	

Young families, new mortgages,
long-term income replacement

Advantages of Term Life

- Lowest cost: A healthy 35-year-old can often get \$500,000 of 20-year term coverage for \$25-\$40/month.
- Simple and easy to understand — pure protection with no investment component.
- Level premiums provide predictable, budget-friendly coverage.
- Convertibility options allow upgrading to permanent coverage without a new medical exam.

Disadvantages of Term Life

- No cash value — premiums are a pure expense with no savings or investment component.
- Coverage ends at the end of the term — if you still need insurance, renewal rates can be 5-10x higher.
- Does not provide lifelong protection unless converted to a permanent policy.
- No living benefits (no policy loans, no cash accumulation).

When Term Makes Sense: Term life is ideal when you have a specific, time-limited need — like covering a 20-year mortgage or replacing income until your children are grown. It provides the maximum death benefit per premium dollar.

Chapter 3: Whole Life Insurance

Whole life insurance is the oldest and most traditional form of permanent life insurance. It provides a guaranteed death benefit for your entire lifetime (as long as premiums are paid), a guaranteed cash value that grows over time, and potentially dividends from the issuing insurance company.

How Whole Life Works

1. You pay a fixed premium for life (or for a specified "paid-up" period like 10, 20, or 65 years).
2. A portion of each premium goes toward the cost of insurance; the remainder builds cash value.
3. Cash value grows at a guaranteed rate set by the insurance company (typically 2-4%).
4. Participating whole life policies may pay annual dividends, which can be used to buy additional coverage, reduce premiums, or accumulate as cash.

5. You can borrow against the cash value through policy loans at favorable interest rates.
6. The death benefit is paid to your beneficiaries income tax-free when you pass away.

Cash Value Growth

The cash value in a whole life policy grows on a tax-deferred basis. In the early years, cash value growth is slow because a larger portion of the premium covers the cost of insurance and company expenses. Over time, the cash value accelerates, particularly in well-funded policies from mutual insurance companies that pay dividends.

Policy Year	Annual Premium	Cash Value (Guaranteed)	Cash Value (w/ Dividends)	Death Benefit
Year 1	\$10,000	\$2,500	\$3,000	\$500,000
Year 5	\$10,000	\$25,000	\$32,000	\$500,000
Year 10	\$10,000	\$65,000	\$85,000	\$500,000
Year 20	\$10,000	\$170,000	\$240,000	\$520,000+
Year 30	\$10,000	\$310,000	\$470,000	\$560,000+

Note: Values shown are illustrative only and vary by company, age, health, and dividend performance. Dividends are not guaranteed.

Advantages of Whole Life

- Guaranteed death benefit for life — coverage never expires.
- Guaranteed cash value growth — no market risk.
- Potential dividends from mutual insurance companies (not guaranteed but historically reliable).
- Tax-deferred cash value growth and tax-free death benefit.
- Policy loans provide access to cash without triggering a taxable event.
- Creditor protection in many states.

Disadvantages of Whole Life

- Significantly higher premiums than term life — often 5-15x more expensive for the same death benefit.
- Low guaranteed cash value returns compared to market investments.
- Limited flexibility — premiums are fixed and the policy structure is rigid.
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Slow cash value accumulation in early years (high surrender charges).

- Complexity — dividends, paid-up additions, and loan provisions can be confusing.

When Whole Life Makes Sense: Whole life is best for individuals who want guaranteed lifetime coverage with predictable, conservative cash value growth. It is commonly used in estate planning (often held in an Irrevocable Life Insurance Trust), business succession planning, and for individuals who value guaranteed returns over market-based growth.

Chapter 4: Universal Life Insurance

Universal life (UL) insurance was introduced in the 1980s as a more flexible alternative to whole life. It provides a death benefit with adjustable premiums and an interest-crediting cash value component. The policyholder has more control over premium payments and death benefit levels.

How Universal Life Works

1. You pay premiums that can vary in amount and timing (within limits).
2. The insurance company deducts the monthly cost of insurance and policy charges from your account value.
3. The remaining balance earns interest at a rate declared by the insurer (subject to a guaranteed minimum, often 2-3%).
4. You can increase or decrease the death benefit (subject to underwriting for increases).
5. You can adjust premiums up or down — even skip payments if sufficient cash value exists to cover charges.
6. Cash value can be accessed through policy loans or partial withdrawals.

Advantages of Universal Life

- Premium flexibility — adjust payments based on your financial situation.
- Adjustable death benefit — increase (with underwriting) or decrease as needs change.
- Tax-deferred cash value growth and tax-free death benefit.
- Generally lower premiums than whole life for the same death benefit.
- Transparent — you can see exactly how much goes to insurance costs vs. cash value.

Disadvantages of Universal Life

- Interest rates are not guaranteed beyond the minimum — if current rates drop, cash value growth slows.
- Underfunding the policy can cause it to lapse, losing all coverage and triggering tax consequences.
- Increasing cost of insurance as you age — if cash value is insufficient, premiums may need to increase dramatically.
- Requires active monitoring and management.
- Some older UL policies with low guaranteed minimums have become problematic in the low-interest-rate environment.

Chapter 5: Indexed Universal Life (IUL)

Indexed Universal Life insurance combines the flexible structure of universal life with an interest-crediting mechanism tied to the performance of a market index — most commonly the S&P 500. IUL offers upside potential with downside protection through a combination of caps, floors, and participation rates.

How Indexing Works

Unlike directly investing in the stock market, IUL policies use a crediting method based on the change in an index over a defined period. The key parameters are:

Parameter	Description	Example
Floor	Minimum interest credit (protects against losses)	0% (you never lose money due to market decline)
Cap	Maximum interest credit in a period	9-12% (varies by carrier and product)
Participation Rate	Percentage of index gain credited	100% of gain up to cap; or 50-80% uncapped
Crediting Period	How often gains are calculated	Annual point-to-point (most common)
Spread/Margin	Some strategies deduct a spread instead of using a cap	1.5-3% deducted from gross gain

Crediting Method Example: Annual Point-to-Point

With an annual point-to-point method, the index value is measured at the start and end of a one-year segment. If the S&P 500 goes from 4,500 to 5,100 (a 13.3% gain), and your cap is 10%, you receive a 10% credit. If the S&P 500 drops 15%, your 0% floor means you are credited 0% — you do not lose money.

Index Return	Cap (10%)	Floor (0%)	Your Credit
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+25%	10% cap applies	—	10.0%
+13%	10% cap applies	—	10.0%
+8%	Under cap	—	8.0%
+3%	Under cap	—	3.0%
0%	—	Floor applies	0.0%
-10%	—	Floor protects	0.0%
-30%	—	Floor protects	0.0%

Key Benefit: The 0% floor is the defining feature of IUL. In years when the market declines, your cash value does not decrease due to market losses (though policy charges still apply). Over time, avoiding losses can be as valuable as capturing gains — this is the concept of "locking in" gains each year.

Cash Value Growth in IUL

IUL cash value growth depends on premium funding, index performance, cap/floor parameters, and policy charges. Well-funded IUL policies have historically provided cash value growth in the range of 5-7% net over long periods, though this is not guaranteed and actual results vary.

Tax-Free Income from IUL

One of the most powerful features of IUL is the ability to access cash value through tax-free policy loans under IRC Section 7702. When structured properly:

1. Cash value grows tax-deferred inside the policy.
2. You borrow against the cash value — loans are not taxable income.
3. The borrowed amount continues to earn index credits (in most policy designs).
4. You use the loan proceeds as tax-free retirement income.
5. The outstanding loan balance is repaid from the death benefit upon your passing.

Advantages of IUL

- Upside potential tied to market index performance.

- Downside protection through the 0% floor — no market losses to cash value.
- Tax-free income through policy loans.
- Flexible premiums and adjustable death benefit.
- No contribution limits (unlike 401(k)s or IRAs) — fund as much as policy design allows.
- No Required Minimum Distributions.
- Tax-free death benefit to beneficiaries.

Disadvantages of IUL

- Caps limit upside in strong market years.
- Policy charges (cost of insurance, administrative fees) reduce net returns.
- Complexity — understanding caps, floors, participation rates, and loan mechanics requires education.
- If underfunded or if the policy lapses with an outstanding loan, the loan becomes taxable income.
- Illustrations may show optimistic assumptions — always review guaranteed values.
- Not a replacement for traditional investments — best used as a complement to a diversified plan.

IUL policies require careful design, adequate funding, and ongoing monitoring. An underfunded IUL can erode cash value over time as cost-of-insurance charges increase with age. Always work with a qualified insurance professional who can illustrate both guaranteed and non-guaranteed scenarios.

Chapter 6: Side-by-Side Comparison

The following table provides a high-level comparison of the four major types of life insurance discussed in this guide. Use this as a starting point for discussions with your advisor.

Feature	Term Life	Whole Life	Universal Life	Indexed UL
Premium Cost	Lowest	Highest	Moderate	Moderate-High
Premium Flexibility	Fixed for term	Fixed	Flexible	Flexible
Coverage Duration	Specific term	Lifetime	Lifetime	Lifetime
Cash Value	None	Guaranteed growth	Interest-based	Index-linked
Growth Potential	N/A	Conservative (2-4%)	Moderate (2-5%)	Moderate-High (0-12%)

Downside Protection	N/A	Guaranteed	Guaranteed minimum	0% floor
Death Benefit	Level	Level or increasing	Adjustable	Adjustable
Tax-Free Income	No	Yes (loans)	Yes (loans)	Yes (loans)
Complexity	Very Simple	Simple	Moderate	Complex
Best For	Temporary need, budget	Guaranteed lifetime, estate	Flexible needs	Growth + protection

Chapter 7: Needs Analysis Framework

Determining how much life insurance you need is a critical first step. Two common methods are the Income Multiplier approach and the DIME method.

Income Multiplier Method

The simplest approach is to multiply your annual gross income by a factor of 10-12. This provides a rough estimate of the coverage needed to replace your income for your family.

Annual Income	10x Multiplier	12x Multiplier
\$75,000	\$750,000	\$900,000
\$100,000	\$1,000,000	\$1,200,000
\$150,000	\$1,500,000	\$1,800,000
\$200,000	\$2,000,000	\$2,400,000
\$300,000	\$3,000,000	\$3,600,000

The DIME Method

For a more tailored analysis, the DIME method accounts for four key financial needs:

1. Debt: Total all outstanding debts — credit cards, car loans, student loans, personal loans.
- 2.

Income: Calculate the number of years your family would need income replacement, multiplied by your annual income. For example, if your youngest child is 5 and you want coverage until they are 22, that is 17 years of income.

3. Mortgage: Include the full remaining balance on your mortgage(s).
4. Education: Estimate the cost of college or private school for each child. A four-year public university averages approximately \$25,000-\$30,000/year; private universities can exceed \$60,000/year.

DIME Calculation Example

Category	Amount
Debt (credit cards, car loans, student loans)	\$45,000
Income (17 years x \$100,000)	\$1,700,000
Mortgage balance	\$350,000
Education (2 children x \$120,000 each)	\$240,000
TOTAL COVERAGE NEEDED	\$2,335,000

Pro Tip: Consider subtracting existing savings, investments, and any current life insurance coverage from the DIME total to determine the additional coverage gap. Also factor in your spouse's income — if they earn enough to cover basic expenses, you may need less income replacement coverage.

Chapter 8: Tax Advantages of Life Insurance

Life insurance enjoys some of the most favorable tax treatment under the Internal Revenue Code. Understanding these advantages can help you use life insurance as part of a comprehensive financial plan.

IRC Section 7702

Section 7702 defines what qualifies as a life insurance contract for tax purposes. To receive favorable tax treatment, a policy must meet either the Cash Value Accumulation Test or the Guideline Premium/Cash Value Corridor Test. Properly designed policies that meet these tests receive the following benefits:

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Tax-Free Death Benefit: The death benefit paid to beneficiaries is not subject to federal income tax (IRC Section 101(a)).

- **Tax-Deferred Cash Value Growth:** Interest, dividends, and index credits within the policy grow without current income taxation.
- **Tax-Free Policy Loans:** Loans taken against the cash value are not taxable income (as long as the policy remains in force).
- **Tax-Free Withdrawals Up to Basis:** You can withdraw up to your total premium payments (your basis) without income tax.

Modified Endowment Contract (MEC)

If a policy is funded too aggressively relative to the death benefit, it may become a Modified Endowment Contract (MEC). A MEC loses some tax advantages:

- Withdrawals and loans are taxed on a "last in, first out" (LIFO) basis — gains are distributed first and are taxable.
- A 10% penalty applies to distributions taken before age 59 and a half.
- The death benefit remains income tax-free.
- A MEC cannot be "undone" — once a policy becomes a MEC, it stays a MEC.

Avoiding MEC Status: When using IUL or whole life for retirement income planning, it is critical that the policy is designed to stay within the 7-pay test limits defined by IRC Section 7702A. Your insurance professional should design the policy with appropriate death benefit levels to avoid MEC status.

Chapter 9: Beneficiary Planning

Proper beneficiary designation is one of the most overlooked aspects of life insurance planning. Beneficiary designations override your will, so keeping them current is essential.

Types of Beneficiaries

Type	Description	Example
Primary Beneficiary	First in line to receive the death benefit	Spouse, adult child
Contingent Beneficiary		Children, siblings, trust

	Receives benefit if primary beneficiary predeceases you	
Per Stirpes	If a beneficiary dies, their share passes to their descendants	Children inherit their deceased parent's share
Per Capita	If a beneficiary dies, their share is divided equally among surviving beneficiaries	All surviving named individuals split equally

Common Beneficiary Mistakes

- Naming your estate as beneficiary — subjects proceeds to probate, potential creditors, and delays.
- Failing to update after divorce — your ex-spouse may still be the beneficiary.
- Naming minor children directly — minors cannot receive insurance proceeds; a court-appointed guardian would manage the funds.
- Not naming contingent beneficiaries — if the primary beneficiary predeceases you and there is no contingent, proceeds go to your estate.
- Forgetting to update after major life events — marriage, divorce, birth of children, death of a beneficiary.

Trust as Beneficiary

Naming a trust as the beneficiary of your life insurance policy can provide significant advantages:

- Control over how and when proceeds are distributed to beneficiaries.
- Protection from creditors and divorce proceedings.
- Professional management of funds for minor children or beneficiaries who may not handle large sums responsibly.
- Estate tax benefits when using an Irrevocable Life Insurance Trust (ILIT) — death benefit is excluded from your taxable estate.

Chapter 10: Action Steps

Life insurance decisions should be made thoughtfully, with a clear understanding of your needs, goals, and financial situation. Use the following action items as your guide.

Immediate Action Items

1. Conduct a needs analysis — use the DIME method or income multiplier to determine your coverage need.
- 2.

Review existing coverage — evaluate any group life insurance through your employer (typically 1-2x salary, which may be insufficient).

3. Determine your budget — understand how much you can allocate to life insurance premiums without straining your overall financial plan.
4. Get quotes — compare term life quotes from multiple carriers for your baseline protection need.
5. Evaluate permanent insurance needs — if you have estate planning goals, retirement income supplementation needs, or lifelong coverage requirements, explore whole life, UL, or IUL options.

Key Questions to Discuss with Your Advisor

- What is my current coverage gap?
- Should I layer term and permanent coverage for optimal cost and protection?
- What is my time horizon for needing the coverage?
- Am I healthy enough to qualify for preferred rates?
- Does an IUL or whole life policy make sense as a supplemental retirement income vehicle in my overall plan?
- Should I own the policy personally, or should it be held in an Irrevocable Life Insurance Trust (ILIT)?
- Are my beneficiary designations current and aligned with my estate plan?

Annual Review Checklist

- Review beneficiary designations on all policies.
- Verify coverage amounts are still adequate (especially after major life events).
- For permanent policies: review cash value performance, in-force illustrations, and funding adequacy.
- For IUL policies: review cap rates, index performance, and cost-of-insurance charges.
- Ensure policies are not in danger of lapsing due to insufficient premiums or declining cash value.
- Evaluate whether policy loans are affecting the long-term health of the policy.

Next Step: Schedule a complimentary life insurance review with a BrightAdvisor® professional. We will assess your current coverage, identify gaps, and recommend a personalized strategy that aligns with your financial goals. Call (602) 497-0277 or visit brightadvisor.com.

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