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Universal Life Insurance and Retirement Planning

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Life Insurance Basics

Life insurance is an agreement between you (the policy owner) and an insurer. Under the terms of a life insurance policy, the insurer promises to pay a certain sum to a person you choose (your beneficiary) upon your death, in exchange for your premium payments. Proper life insurance coverage should provide you with peace of mind, since you know that those you care about will be financially protected after you die.

The many uses of life insurance

One of the most common reasons for buying life insurance is to replace the loss of income that would occur in the event of your death. When you die and your paychecks stop, your family may be left with limited resources. Proceeds from a life insurance policy make cash available to support your family almost immediately upon your death. Life insurance is also commonly used to pay any debts that you may leave behind. Life insurance can be used to pay off mortgages, car loans, and credit card debts, leaving other remaining assets intact for your family. Life insurance proceeds can also be used to pay for final expenses and estate taxes. Finally, life insurance can create an estate for your heirs.

How much life insurance do you need?

Your life insurance needs will depend on a number of factors, including whether you're married, the size of your family, the nature of your financial obligations, your career stage, and your goals. For example, when you're young, you may not have a great need for life insurance. However, as you take on more responsibilities and your family grows, your need for life insurance increases.

There are plenty of tools to help you determine how much coverage you should have. Your best resource may be a financial professional. At the most basic level, the amount of life insurance coverage that you need corresponds directly to your answers to these questions:

- What immediate financial expenses (e.g., debt repayment, funeral expenses) would your family face upon your death?
- How much of your salary is devoted to current expenses and future needs?
- How long would your dependents need support if you were to die tomorrow?
- How much money would you want to leave for special situations upon your death, such as funding your children's education, gifts to charities, or an inheritance for your children?

Since your needs will change over time, you'll need to continually re-evaluate your need for coverage.

How much life insurance can you afford?

How do you balance the cost of insurance coverage with the amount of coverage that your family needs? Just as several variables determine the amount of coverage that you need, many factors determine the cost of coverage. The type of policy that you choose, the amount of coverage, your age, and your health all play a part. The amount of coverage you can afford is tied to your current and expected future financial situation, as well. A financial professional or insurance agent can be invaluable in helping you select the right insurance plan.

What's in a life insurance contract?

A life insurance contract is made up of legal provisions, your application (which identifies who you are and your medical declarations), and a policy specifications page that describes the policy you have selected, including any options and riders that you have purchased in return for an additional premium.

Provisions describe the conditions, rights, and obligations of the parties to the contract (e.g., the grace period for payment of premiums, suicide and incontestability clauses).

The policy specifications page describes the amount to be paid upon your death and the amount of premiums required to keep the policy in effect. Also stated are any riders and options added to the standard policy. Some riders include the waiver of premium rider, which allows you to skip premium payments during periods of disability; the guaranteed insurability rider, which permits you to raise the amount of your insurance without a further medical exam; and accidental death benefits.

The insurer may add an endorsement to the policy at the time of issue to amend a provision of the standard contract.

Types of life insurance policies

The two basic types of life insurance are term life and permanent (cash value) life. Term policies provide life insurance protection for a specific period of time. If you die during the coverage period, your beneficiary receives the policy death benefit. If you live to the end of the term, the policy simply terminates, unless it automatically renews for a new period. Term policies are available for periods of 1 to 30 years or more and may, in some cases, be renewed until you reach age 95. Premium payments may be increasing, as with annually renewable 1-year (period) term, or level (equal) for up to 30-year term periods.

Permanent insurance policies provide protection for your entire life, provided you pay the premium to keep the policy in force. Premium payments are greater than necessary to provide the life insurance benefit in the early years of the policy, so that a reserve can be accumulated to make up the shortfall in premiums necessary to provide the insurance in the later years. Should the policyowner discontinue the policy, this reserve, known as the cash value, is returned to the policyowner. Permanent life insurance can be further broken down into the following basic categories:

- **Whole life:** You generally make level (equal) premium payments for life. The death benefit and cash value are predetermined and guaranteed. The policyowner's only action after purchase of the policy is to pay the fixed premium. Any guarantees associated with payment of death benefits, income options, or rates of return are based on the claims-paying ability of the insurer.
- **Universal life:** You may pay premiums at any time, in any amount (subject to certain limits), as long as policy expenses and the cost of insurance coverage are met. The amount of insurance coverage can be decreased, and the cash value will grow at a declared interest rate, which may vary over time.
- **Variable life:** As with whole life, you pay a level premium for life. However, the death benefit and cash value fluctuate depending on the performance of investments in what are known as subaccounts. A subaccount is a pool of investor funds professionally managed to pursue a stated investment objective. The policyowner selects the subaccounts in which the cash value should be invested.
- **Variable universal life:** A combination of universal and variable life. You may pay premiums at any time, in any amount (subject to limits), as long as policy expenses and the cost of insurance coverage are met. The amount of insurance coverage can be decreased, and the cash value goes up or down based on the performance of investments in the subaccounts.

Note: *Variable life and variable universal life insurance policies are offered by prospectus, which you can obtain from your financial professional or the insurance company. The prospectus contains detailed information about investment objectives, risks, charges, and expenses. You should read the prospectus and consider this information carefully before purchasing a variable life or variable universal life insurance policy.*

Choosing and changing your beneficiaries

You must name a primary beneficiary to receive the proceeds of your insurance policy. You may name a contingent beneficiary to receive the proceeds if your primary beneficiary dies before the insured. Your beneficiary may be a person, corporation, or other legal entity. You may name multiple beneficiaries and specify

what percentage of the net death benefit each is to receive. You should carefully consider the ramifications of your beneficiary designations to ensure that your wishes are carried out as you intend.

Generally, you can change your beneficiary at any time. Changing your beneficiary usually requires nothing more than signing a new designation form and sending it to your insurance company. If you have named someone as an irrevocable (permanent) beneficiary, however, you will need that person's permission to adjust any of the policy's provisions.

Where can you buy life insurance?

You can often get insurance coverage from your employer (i.e., through a group life insurance plan offered by your employer) or through an association to which you belong (which may also offer group life insurance). You can also buy insurance through a licensed life insurance agent or broker, or directly from an insurance company.

Any policy that you buy is only as good as the company that issues it, so investigate the company offering you the insurance. Ratings services, such as A. M. Best, Moody's, and Standard & Poor's, evaluate an insurer's financial strength. The company offering you coverage should provide you with this information.

Comparison of Types of Life Insurance

	Term	Whole Life	Universal Life	Variable Life	Variable Universal Life
Premium	Premiums start low, increase at each renewal	Level	Flexible	Level	Flexible
Coverage	Usually renewable until at least age 70; for some policies, up to age 95	For life	For life	For life	For life
Death benefit	Guaranteed	Guaranteed	May be guaranteed, depending on policy	Guaranteed	May be guaranteed, depending on policy
		May increase with dividends*	Can be increased or decreased	Varies relative to cash value investment returns	Can be increased or decreased; varies relative to cash value investment returns
Cash value	None	Guaranteed	Guaranteed minimum interest rate	Not guaranteed	Not guaranteed
		May increase with dividends*	Varies based on interest rates	Fluctuates with underlying investment performance	Fluctuates with underlying investment performance
Policy loans allowed?	Not applicable	Yes	Yes	Yes	Yes
		May be able to borrow up to 100% of total cash surrender value less annual loan interest rate	Same as whole life, but usually available at lower net interest rate (i.e., pay the interest rate and get a credit back to the policy)	Same as whole life, but usually available at lower net interest rate (i.e., pay the interest rate and get a credit back to the policy)	Same as whole life, but usually available at lower net interest rate (i.e., pay the interest rate and get a credit back to the policy)
Cash withdrawals allowed?	Not applicable	No	Yes	No	Yes

Cash value account growth	No cash value account	Insurance company determines guaranteed cash value and declares dividends based on performance of its general investment portfolio*	Insurance company determines cash value interest crediting rates based on current interest rate returns to the company	Cash value account growth depends upon the investment performance of the subaccounts you choose	Cash value account growth depends upon the investment performance of the subaccounts you choose
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*Dividends are not guaranteed.

Note: Any guarantees associated with payment of death benefits, income options, or rates of return are subject to the claims-paying ability of the insurer.

Note: Policy loans and withdrawals will reduce the policy's cash value and death benefit and may cause the policy to lapse. Withdrawals may be subject to surrender charges and income tax, and a 10% penalty may apply to withdrawals from a modified endowment contract if made under age 59½.

Term vs. Cash Value Life Insurance

Which type of life insurance is better--term or cash value? Insurance buyers have been asking this question for generations. When choosing between these two fundamentally different alternatives, you'll need to think about the amount of coverage you need, the amount of money you can afford to spend, and the length of time you need the coverage to continue.

Term insurance

Term insurance is often referred to as pure insurance. Term policies provide life insurance coverage for a specified period of time. You can typically buy term insurance for periods ranging from 1 to 30 years. If you die during the policy period, your beneficiary receives the policy death benefit. If you don't die during the term, your beneficiary receives nothing. At the end of the specified policy term, your coverage simply ends. You may be able to renew your policy without a physical exam, but at a much higher premium. Once you reach a certain age (usually 70 and older), you may find it difficult to get term insurance coverage--and if you can, the premiums will be very expensive. There are several variations of term life. You can buy a level death benefit or a decreasing death benefit with premiums that increase annually, or that are level for a period of years (5, 10, 15, 20, 25, or 30).

Cash value insurance

Cash value insurance, often called permanent insurance, is life insurance that is designed to have you pay a "levelized" premium throughout your life. In some cases, you may fund a cash value policy in a way that the cash values can be used in later years to pay future premiums. As long as you continue paying your premiums by whatever means, cash value life insurance continues throughout your life, regardless of your age or your health. As you pay your premiums, a portion of each payment is placed in the cash value account. During the early years of the policy, the cash value contribution is a large portion of each premium payment. As you get older, and the true cost of your insurance increases, the portion of your premium payment devoted to the cash value decreases. The cash value continues to grow--tax deferred--as long as the policy is in force. You can borrow against the cash value, but unpaid policy loans will reduce the death benefit that your beneficiary will receive. If you surrender the policy before you die (i.e., cancel your coverage), you'll be entitled to receive the cash value, minus any loans and surrender charges. Many different types of cash value life insurance are available, including whole life, variable life, universal life, and variable universal life.

Making a choice

Term insurance coverage typically costs less than cash value insurance coverage when you're younger, but because the cost of a term policy is based on your age, the cost may eventually exceed that of cash value if you continue to renew your term policy. In contrast, these factors are taken into consideration when cash value insurance premiums are set. As a result, certain cash value policy premiums typically remain the same throughout the life of the policy.

In some cases, the choice may be clear. For instance, your insurance need may be so large that the only way you can afford to meet it is by purchasing lower-premium term insurance. Or, you may need the coverage only for a few years, again making term insurance the logical choice. But if you can afford to pay higher premiums, and you need long-term protection, you may want to consider cash value insurance.

In some cases, you may want to have both types of life insurance coverage. For instance, if you want to have some life insurance at the time of your death, you might consider buying the bulk of your life insurance as term and a smaller portion as cash value. When your need for life insurance decreases, the term policy could be discontinued and the cash value policy kept. It's also possible to buy a term policy that is convertible to a whole life policy later.

Cash Value Life Insurance

What is it?

Overview

In broad terms, life insurance can be categorized as either (1) term insurance, which lasts for a finite period of time (e.g., 1, 5, 30 years) and simply provides a death benefit, or (2) permanent insurance (e.g., whole life, variable life, universal life), which also provides a death benefit, but will remain in effect as long as the premiums continue to be paid, regardless of how long the insured lives. Permanent insurance is accomplished by "over funding" the cost for the "pure" death benefit in the early years of the policy. This way the premium can remain level even as the insured ages and the cost of the "pure" life insurance increases. The "over funding" is accounted for in what is known as the cash value account. The cash value is the nonforfeiture value the policyowner is entitled to if all or part of the policy is terminated prior to payment of the death benefit. The cash value of the policy is often referred to as the investment component.

A major benefit of cash value insurance is that the policyowner can borrow from the insurance company against the accumulated cash value, often at a relatively low interest rate. Those funds can be used to finance retirement plans, pay college tuition, assist a child with a mortgage, or for any other purpose.

For more information on life insurance, see Policy Types.

Whole life

For those who elect to buy a whole life policy, insurers will deposit the portion of the premium you pay that is not used for expenses, taxes, and mortality costs, in their "general account." Insurers invest money in their general account primarily in long-term fixed-rate securities (e.g., bonds, mortgages) that typically provide modest returns to the company. Some of the investment returns may be paid to the policyowner through dividend distributions (if applicable), but these returns reflect the insurance company's overall performance and are not guaranteed. Policyowners have no control over how the funds are invested or how the returns are generated. However, the insurance company will guarantee a minimum cash value accumulation.

Caution: Guarantees are subject to the claims-paying ability of the issuing insurance company.

Whole life policies have several drawbacks. Because the cash value grows from primarily fixed-rate investments, they generally provide long-term returns that can be significantly less than what can be earned on other types of investments. Further, the policyowner is unable to influence the cash value account investment allocation.

In addition to whole life, insurers have developed other types of cash value policies, including variable life, universal life, and variable universal life, that offer more flexibility.

Variable life

With a variable life insurance policy, policyholders have a choice in deciding how to invest the cash value account in their policy. The cash values are held in subaccounts. The insurance company will usually offer a wide variety of investment options, such as domestic investment vehicles and international stock, as well as a fixed rate option, so that the policyowner can diversify the cash value account with selections that are most appropriate for his or her personal financial situation. The return on the cash value account will be dependent on the performance of the underlying subaccounts. There is no guaranteed minimum cash value as with whole life. A variable policy may be appropriate for those who can tolerate the degree of risk associated with each type of investment and who want more control over their financial assets.

Universal life

With a universal life policy, the insurer invests the cash value in a fixed-rate account that is subject to change at regular intervals. Policyowners have no control over how the funds are invested. These accounts can yield attractive returns when rates on fixed-rate investments are high. However, long-term returns can't easily be predicted. The insurance company will provide a predetermined minimum interest rate on the cash value account. Universal life policies typically allow policyowners to raise or lower their premiums on an annual basis, unlike whole life or variable life. This flexibility with premium payments is one of the primary advantages of universal life.

Variable universal life

Variable universal life insurance policies, a combination of universal life and variable life, provide policyholders with the investment option and control features of variable life and the premium and withdrawal features of universal life. Like variable life, variable universal life gives the policyowner the freedom to choose how his or her cash values are invested. A variable universal life policy may be appropriate for someone who can tolerate the higher degree of risk involved, and who wants maximum flexibility for premium payments and withdrawals.

The "living benefits" of your policy

Loans

One of the benefits of cash value life insurance is the ability to borrow from the insurer using the policy cash value as collateral. All permanent life policies typically allow policyholders to borrow against their cash value.

The insurer makes the loan from the insurance company's general funds, using the policy's cash value as collateral. Some policies set the interest rate at an amount equal to the amount the company credits to the policy's cash value. Other policies set the amount slightly higher than the amount credited to the cash value. Interest starts accruing immediately, and is either fixed for the life of the contract or changes periodically in step with a published bond index.

Caution: Taking a loan against an insurance policy reduces both the cash value and the death benefit. While there is no requirement to pay back a loan, if it is not repaid before the insured's death, any outstanding loans and interest will reduce the death benefit that beneficiaries receive.

Caution: Policy loans generally do not generate immediate tax liability for the policyowner as long as the policy remains in force. However, if the policy lapses or is surrendered, the policyowner will be required to include the outstanding loan balance as gross income to the extent the loan proceeds exceed the investment (premiums) in the policy.

Withdrawals

Variable universal life and universal life insurance policies also allow policyholders to make withdrawals. To make a withdrawal, one only needs to pay a small administrative fee. The downside to policy withdrawals is that they permanently reduce the policy's cash value and death benefit. In addition, if the policy is classified as a modified endowment contract (MEC), withdrawals, including loans and partial surrenders, will be subject to immediate taxation to the extent that the policy's cash value exceeds the premiums paid. In addition, withdrawals from a MEC made prior to age 59½ may result in a 10 percent penalty, unless an exception applies.

Comparison of Types of Cash Value Life Insurance

	Whole Life	Variable Life	Universal Life	Variable Universal
Earnings grow tax deferred	Yes	Yes	Yes	Yes
Cash value may be withdrawn tax free*	Within limits	No	Within limits	Within limits
Policy loan proceeds received tax free* (Note: Special tax rules apply if policy is later cancelled)	Yes	Yes	Yes	Yes
Policyowner controls choice of investments	No	Yes	No	Yes
Policyowner can change premium payment amount	No	No	Yes	Yes
Policyowner can control premium payment timing	No	No	Yes	Yes
Cash value growth guaranteed by insurance company**	Yes	No	Yes	No
Partial withdrawals of cash value allowed*	Yes	No	Yes	Yes
Policy loans allowed*	Yes	Yes	Yes	Yes
Cash values may be used to pay monthly deductions*	No	No	Yes	Yes

*Policy loans, withdrawals, and payments made from the policy's cash value may reduce the policy's cash value and death benefit and may cause an investor to receive less than the original amount invested. Withdrawals may be subject to surrender charges and income tax. Penalties may apply to withdrawals made before age 59½ if the policy is a modified endowment contract.

**Any guarantees associated with payment of death benefits, income options, or rates of return are subject to the claims-paying ability of the insurer.

Using Cash Value Life Insurance for Retirement Savings

What is using cash value life insurance for retirement savings?

One of the more popular uses for cash value life insurance is to save for your retirement. Cash value life insurance refers to a wide variety of insurance policies that provide both a death benefit and the accumulation of cash value over a period of time. Cash value life insurance can range from a traditional level premium whole life policy to a single premium whole life policy to a universal life policy to a variable life insurance policy or a variable universal life policy. In today's insurance marketplace, there are a wide variety of cash value life insurance policies that a consumer can buy. These types of insurance policies are in contrast to a term life insurance policy in which you make a series of premium payments and your beneficiaries collect the insurance amount if you die during the term of the policy. There is no buildup of cash value with a term life policy.

Many people use a cash value life insurance policy to save for their retirement and to provide a death benefit to their beneficiaries. In very rare instances, companies offer their employees an option under their retirement plan to purchase life insurance. Under a qualified retirement plan, amounts contributed to the plan by the employer will be tax deductible and, in the case of a 401(k) plan, amounts contributed to the plan by an employee also will be tax deductible. Any increases in the cash value part of the policy due to investment or interest gains will be tax deferred until the money is withdrawn from the policy. Some people will also use a cash value life insurance policy as a supplement to a qualified retirement plan. If you work for a company that does not offer a qualified retirement plan (or does not offer a life insurance option in an existing plan) or if you have already contributed the maximum amount to your qualified retirement plan, a cash value insurance policy can offer some of the tax benefits of a qualified retirement plan. Although the payment of the insurance premiums is not tax deductible, any increase in the cash value of the insurance policy due to investment gains is not taxed until you begin to withdraw the money after you retire. The cash value grows tax deferred (like an annuity). Furthermore, the withdrawals may not be taxable if you utilize the tax-favored withdrawal provisions cash value policies offer.

When should you use cash value life insurance for retirement savings?

To provide a death benefit to your family and to save for your retirement

You should use a cash value life insurance policy for your retirement savings if you would like to provide life insurance for your family, as well as save for your retirement in one combined insurance and investment vehicle. A cash value life insurance policy consists of two parts: a life insurance part and an investment part. Although you pay one premium for the total insurance policy, the premium you pay each year is divided between the payment for the insurance and the payment for the investment savings.

Life insurance

You should purchase a cash value policy if you have a need for life insurance. Whether you need life insurance involves several factors. First, do you have dependents (a spouse or children or even elderly parents) who rely on your income to maintain their standards of living? If you do, you should have life insurance to provide for your dependents in the event of your premature death. Second, even if you do not work (i.e., you are a "stay-at-home spouse"), do you provide services that your spouse would have to pay for if you were not around (such as child care, housekeeping, cooking, etc.)? Then you may need life insurance as well. Third, do you have such a large estate that substantial estate taxes will be incurred upon your death? Life insurance may be an excellent way to provide this liquidity to your heirs.

What are the strengths of using cash value life insurance for retirement savings?

Life insurance protection for your family

One of the main strengths of using cash value life insurance for retirement savings is to provide life insurance protection to your family in the event of your premature death. If you save for your retirement by buying mutual funds or Treasury bills or by simply investing your money in a savings account at the bank, you will not have any life insurance. You would have to buy a separate insurance policy on your life. By buying a cash value life insurance policy, you can combine life insurance protection for your family with a savings vehicle for your retirement.

Premiums may be tax deductible

If your employer offers the option to purchase life insurance through the company's qualified retirement plan, then, within limits, your (and your company's) tax-deductible contributions into the retirement plan may be used to purchase the insurance policy. Thus, using a cash value life insurance policy to save for your retirement can be an excellent way to buy a substantial life insurance policy on your life and save for your retirement, all for a discounted cost.

Caution: Very few companies offer the option to purchase life insurance through their qualified retirement plans. There are complicated rules and limits that must be followed to offer life insurance through a qualified plan. Furthermore, there is extensive paperwork that must be completed. Many companies simply do not want to go through the effort to offer this option to their employees. Furthermore, many types of qualified retirement plans (such as IRAs and savings incentive match plans for employees) do not allow life insurance to be purchased through the plan.

Policy values grow tax deferred

Another benefit to using cash value life insurance to save for your retirement is that the cash value part of the policy grows tax deferred. In this respect, a cash value life insurance policy is similar to an annuity. The cash value portion of the policy grows tax deferred until you begin to withdraw the funds or surrender the policy. Because the cash value grows tax deferred, some people will use a cash value life insurance policy as a supplement to a qualified retirement plan. If your company does not offer a qualified retirement plan or if you have already contributed the maximum amount to your qualified plan, then purchasing a cash value life insurance policy will give you some of the tax benefits of a qualified retirement plan. Although the premiums will not be tax deductible, the increase in the cash value due to interest and investment gains will not be taxed during the accumulation years.

You can withdraw cash values

You may be able to withdraw some of the cash value from your life insurance policy (depending on the type of policy you have). The money can be withdrawn just like a withdrawal from a savings account at your bank. As long as you maintain enough cash value in the policy, you can withdraw the cash from the policy and still keep the life insurance in effect to provide a death benefit for your family.

You can borrow against cash value

You can also borrow against the cash value in your insurance policy. The cash value that has built up in the policy is the collateral for the loan. The interest rate on the loan is determined in advance and is often below rates offered by banks.

Caution: If you die before the loan is fully paid off, the amount of your death benefit is reduced by the amount of the outstanding loan. Furthermore, the policy must remain in force to maintain the favorable tax treatment of the loan.

What are the tradeoffs of using cash value life insurance to save for your retirement?

You must be insurable

You must be deemed "insurable" by an insurance company in order for the insurance company to issue an insurance policy on your life. There are several factors that affect whether you are insurable; the two most important are your age and your medical history. The older you are and the worse your medical history, the more difficult and/or costly it will be to obtain life insurance. For example, a 45-year-old person in perfect health will pay substantially less for a comparable amount of insurance than a 65-year-old person who has already suffered a heart attack.

Cash value life insurance premiums are more expensive than term life premiums

Another tradeoff to using a cash value life insurance policy to save for your retirement is that the premiums for a cash value policy are substantially more expensive than for a comparable amount of term insurance. The premiums are more expensive for a cash value policy because you are paying for both an insurance element and a savings element. With a term policy, you are simply paying for a straight life insurance policy. For example, a 40-year-old man in good health might pay \$600 per year for a 10-year level premium \$500,000 term life insurance policy. That same person might pay \$6,000 per year for a cash value policy with the same death benefit. There may also be higher costs associated with a cash value life insurance policy (e.g., policy fees, higher commissions, premium expense charges, and surrender charges).

Amount of insurance you can purchase may be limited

The insurance company may limit the amount of insurance that you can purchase. If you want to purchase a very large insurance policy on your life, the insurance company may require you to justify the amount of insurance (i.e., prove why you need that much insurance). The insurance company may consider factors such as your income and the size of your assets. For example, if you earn \$50,000 per year, the insurance company may not be willing to issue a policy with a \$5 million death benefit on your life.

Cash value contributions may be limited

Because the cash value grows tax deferred, the federal government has passed laws and issued regulations limiting the amount of money that can be invested in these policies. If these limits are exceeded, the policy may not be treated as a life insurance policy for federal income tax purposes. This is a very technical area. You should consult other resources for more information on the limits on cash value life insurance policies.

Modified Endowment Contract (MEC) rules also limit size of cash value policies

Under federal law, if your premium payments into a cash value life insurance policy exceed certain limits during the first seven years, the policy is then permanently classified as a modified endowment contract (MEC) and is subject to special taxation rules. Under these special rules, policy loans are taxable, and withdrawals may be taxed (and even penalized). The rules concerning MECs are very complex. You should consult other resources before investing in a cash value life insurance policy.

What are the tax implications?***Premium payments may be deductible***

If your company offers the option to purchase life insurance through its qualified retirement plan, then, within limits, your tax-deductible contributions into the plan (and/or your company's contributions) can be used to buy the life insurance policy. Not many companies offer their employees the option to purchase life insurance through their qualified retirement plan. If you do not purchase the insurance policy through a qualified retirement plan, then the premiums will not be tax deductible.

Cash withdrawals in excess of basis are taxable income

When you begin to withdraw cash from a cash value life insurance policy (although only certain types of cash value policies allow withdrawals), the amount of withdrawals up to your basis in the policy will be tax free (your

basis is the amount of premiums you have paid into the policy net of any previous dividends and tax-free withdrawals). Any withdrawals in excess of your basis will be taxed as income. If the policy is classified as a modified endowment contract, then withdrawals will be treated as first coming from earnings and, as a result, will be subject to income tax.

Policy loans are usually not taxable

If you take out a loan against the cash value of your insurance policy, the amount of the loan is not taxable (except in the case of a modified endowment contract). This result is the case even if the loan is larger than the amount of the premiums you have paid in.

Caution: Such a loan is not taxed only as long as the policy is in place.

Interest on policy loans are usually not tax-deductible

The interest on any loans you take out against the cash value of your life insurance is usually not deductible.

Surrender of policy may result in taxable gain

If you surrender your cash value life insurance policy, any gain on the policy may be subject to federal (and possibly state) income tax. The gain on the surrender of a cash value policy is the difference between the net cash value and loan forgiveness amounts and your basis in the policy. Your basis is the total premiums you paid in cash, minus any policy dividends and tax-free withdrawals that you made.

Death benefits are usually not subject to federal income tax

Whoever receives the death benefits from your insurance policy (at the time of your death) usually does not have to include those proceeds in income for federal income tax purposes. One exception to this rule is if the insurance policy has been sold from one policyowner to another, subjecting it to the transfer-for-value rule. Another exception is that with respect to cash value life insurance held in a qualified retirement plan, a portion of the death proceeds equal to the cash value of the policy immediately prior to the insured employee's death will be treated as a plan benefit (not as life insurance proceeds) and therefore will be subject to income tax when distributed to a beneficiary.

Gift Tax

Policy proceeds are usually not considered a gift to beneficiary

The payment of death benefits to a beneficiary from a cash value life insurance policy on your life is usually not considered a taxable gift from you, although it generally is a transfer that is subject to estate tax. One situation where the payment of an insurance death benefit may be subject to the gift tax is when the owner, insured, and beneficiary are three different individuals--for example, when the husband is the owner of the life insurance policy, the wife is the insured, and a child is the beneficiary of the policy. Upon the death of the wife, the husband is considered to have made a gift of the insurance proceeds to the child. This gift may be subject to the gift tax.

Payment of policy premiums are generally not subject to gift tax

If you pay the premiums for an insurance policy on your own life, the payment of the premiums is not considered to be a taxable gift to the beneficiary of the policy. For example, let's say you pay \$5,000 per year in premiums for a \$300,000 cash value insurance policy on your life. Your only child is the named beneficiary on the policy. The payment of this \$5,000 premium is not a taxable gift from you to your child. However, if someone else pays the premiums for a policy that you own, then the payment of those premiums is usually considered to be a taxable gift to you. The gift tax may apply if the annual premiums exceed the annual gift tax exclusion amount. In general, the payment of life insurance premiums made on behalf of another will qualify for the annual exclusion from the gift tax.

Estate Tax

Insurance proceeds may be included in your taxable estate

If you hold any incidents of ownership in an insurance policy or your estate is the beneficiary of the policy, the proceeds from that insurance policy will be included in your taxable estate. Furthermore, if you make a gift of an insurance policy on your life within three years of your death, then the proceeds from that policy will be pulled back into your taxable estate. Incidents of ownership include the right to change the beneficiary, the right to take out policy loans, and the right to surrender the policy for cash, among other things.

Universal Life

What is it?

Permanent (cash value life) insurance with flexible premiums

Universal life is a form of permanent (cash value) insurance. Your cash value receives a guaranteed minimum interest rate plus an excess interest rate when the insurance company's investments perform well, making the returns more competitive than with some other types of policies. (Guarantees are subject to the claims-paying ability of the insurer.) Universal life insurance also offers you flexibility through the ability to change your level of protection, premium amounts, and payment frequency. In this way, your policy can keep pace with changes in your life and your corresponding insurance needs.

Contains unbundled policy elements

Unlike many other types of cash value policies, universal life policies are divided into three elements: protection, expense, and cash value. This unbundling of the policy elements allows you to see the specific charges for each component of your policy, which could make it easier when comparing universal policies from different insurance companies.

When can it be used?

You have a need for insurance and you want a flexible policy

When you have a need for life insurance and a desire for flexible options in your policy, a universal life insurance policy may be appropriate for you. With this type of policy, you choose from two death benefit options and are allowed to change the timing and amount of your premium payment.

You have a long-term cash accumulation need (10 to 15 years)

As part of your overall financial plan, you may be accumulating cash for a specific future need, such as supplementing your retirement or paying for your child's college education. Universal life insurance can be an important financial planning tool that provides your beneficiary with a death benefit when you die. In addition, the policy contains cash values that can be accessed during your lifetime to meet financial goals. The guaranteed rate provided by universal policies may allow you to predict and plan the growth of your cash for specific purposes (within limitations we will discuss later). In general, you should have 10 to 15 years before your funds are needed for your specific goal in order for cash values to have time to accumulate to a substantial amount.

Strengths

Provides benefits common to all cash value insurance

Like all other permanent, cash value policies, a universal life policy contains the following features:

- Cash value grows tax deferred
- Cash value can be borrowed against (policy loans and withdrawals may reduce the policy's cash value and death benefit)

For further information, see Policy Types.

You can change your premium payment without prior notice

Universal life provides for completely flexible premiums. Generally, the policy allows you to increase, decrease, and even skip premiums after the first policy year, as long as the cash value is large enough to cover policy expense charges. You have the ability to change the amount or frequency of your premium payment without giving the insurer prior notice. Most insurers suggest a target premium amount to keep the policy in force.

Tip: Large premium payments in the policy's early years, or at other times when cash is available, can reduce or eliminate the need for premium payments at other times. There may be maximum limits imposed by law to prevent excessive policy funding.

Caution: If your cash accumulation value isn't sufficient to cover the current expense and mortality charges, you may be required to make an additional premium payment in order to prevent a policy lapse.

Caution: If you pay too much premium into the policy during the first seven years of the policy, you could cause the policy to be classified as a modified endowment contract (MEC) for income tax purposes. Distributions and policy loans from MECs are subject to unfavorable income tax treatment, and may also be subject to penalties if taken before age 59½.

Skipped premiums do not create a policy loan

When you skip a premium on your universal life policy, it doesn't create a policy loan. Instead, the amount of the skipped premium is deducted from your cash value account.

Caution: Skipping too many premium payments could erode your cash value account, so be careful.

Offers choice of two death benefit options

Universal life offers you the choice of two death benefit payment options:

Option A (sometimes called option I)--Fixed death benefit, similar to traditional whole life. The death benefit in option A is composed of a pure insurance component plus the cash value. As the cash value grows, the amount of pure insurance is reduced to keep the death benefit constant. The cash value could grow to a level where it would almost equal the death benefit and thus cause the policy to fail to be classified as life insurance for tax purposes, in which case the death benefit would be increased to avoid the policy losing its tax classification.

Option B (sometimes called option II)--Death benefit increases as cash value grows. Option B operates similar to a whole life policy with a term insurance rider equal to the cash value. The death benefit at any time equals a specified level of pure insurance plus the policy cash value.

You can change your death benefit

With a universal life policy, you have the ability to increase or decrease your policy death benefit, providing versatility within the policy and allowing it to adapt to your changing needs and circumstances. As your insurance needs change with time, you can change your coverage to meet these needs without having to take out an additional policy or surrender an existing one. Increases in the policy's death benefit may require a medical exam for proof of insurability.

Tip: Depending on your cash value accumulation, you may be able to increase your death benefit without an increase in premiums. Check with your insurance agent.

Policy cash value may be withdrawn

With a universal policy, you have the ability to withdraw from your cash value by making a partial surrender of your policy. Generally, you can make tax-free withdrawals up to the amount of your policy basis. You may be able to withdraw from your cash values and still keep your insurance in effect to provide a death benefit at your death.

Tip: It's a good idea to leave enough cash value in the policy to maintain the policy and cover the policy fees.

Caution: Cash value withdrawals may reduce the death benefit.

Caution: There may be a surrender fee charged for partial or full surrenders.

Policy cash value receives guaranteed interest rate

With a universal life insurance policy, the insurance company manages your cash value and guarantees a minimum return (guarantees are subject to the claims-paying ability of the insurer). Even if the insurance company's investments perform poorly, you still receive the guaranteed minimum rate of interest on your cash value. This provides you with predictable growth on your cash value and can be especially important when you have specific future financial goals, such as supplementing your retirement, paying your child's college tuition, or estate planning.

Policy cash value may receive excess interest rate

In addition to the guaranteed rate, you may receive an excess interest rate on your cash value. The method of determining excess interest varies by company, and most companies make adjustments to excess interest credits. For example, an insurer may not pay excess interest on the first \$1,000 of cash value, and excess interest is usually not paid on loans taken against the cash value. Some insurers call the excess interest rate the current rate.

Caution: Some companies require a partial forfeiture of excess interest in the event of policy surrender.

Cash value growth can be controlled through premium payments

With a universal life policy, you have some degree of control over your cash value growth. If you pay premiums according to the schedule set by your insurance company, you can predict the growth of your cash values based on the guaranteed interest rate. If you pay more than the suggested premium amount, you can increase the balance in your cash value fund.

Caution: Increasing your premiums could cause the policy to be classified as a modified endowment contract (MEC) for income tax purposes. Distributions and policy loans from MECs are subject to unfavorable income tax treatment, and may also be subject to penalties if taken before age 59½.

Fees are fully disclosed

The separation of the three components (protection, expense, and cash value) in the universal life policy provides you with the ability to monitor the expenses, cost of insurance, and cash value accumulation (something you can't do with traditional whole life and other policy types). Periodically, you receive a statement that details the specific charges applied against your account, as well as premium payments and interest credits. Statements may be issued monthly, quarterly, semiannually, or annually, depending on the company.

Tradeoffs

Cost of insurance (COI) component increases with age

Universal life (UL) policies combine a term life policy with an interest-bearing cash value account. When you pay your premium, part of it may go toward a premium expense charge, while the remainder is applied toward your cash value. That cash value "pot of money" is then impacted in several ways. Interest is added to it, while COI and other fees are withdrawn from it. The COI closely resembles the premiums for annual renewable term insurance, and the cost of the underlying insurance increases each year as you age. As a result, if you choose to reduce or skip premiums, it is possible that your cash value may not be sufficient to cover the COI increases over time.

Tip: Request a new projection of your UL contract every few years. This will allow you to monitor your policy and avoid the possibility of your cash value being insufficient to cover the COI.

Premium reductions could result in policy lapse

The ability to reduce or skip premiums could lead to the temptation to actually do so, exposing you to a potential reduction of cash values to low levels (or even worse, to zero). If this happens, you have two choices: increase premium to keep the policy going and cover the increasing cost of insurance, which could be very expensive; or allow the policy to lapse, which would leave you without insurance protection and could have tax consequences.

Policy loans generally result in lower interest rate credit to cash value

When you take a policy loan, the loan proceeds you receive come from the general fund of the insurance company. The loan amount is not actually withdrawn from your cash value account. However, an amount of your cash value equal to the loan amount is marked as collateral for the loan. The collateral amount usually receives a lower interest rate than the amount not borrowed. Because a portion of your cash value is receiving a lower return, your cash value growth is affected for the duration of the policy loan. Unpaid loans will also reduce the death benefit payable to your survivors.

Changes to death benefit level or option could be a potential tax trap

In order to be considered life insurance under the tax code, a policy must maintain a certain amount of risk to the insurer. A "corridor" must exist between the cash value and the death benefit. In other words, the death benefit can't be composed of cash value only; there must be an insurance element present. If you reduce your death benefit, it could lead to a "force-out"--a distribution of cash from the policy in order to maintain the corridor between the cash value and the death benefit. A distribution resulting from a force-out will be subject to income tax to the extent it represents gain under the policy. A change in the death benefit option from option B (increasing death benefit) to option A (level death benefit) during the first 15 policy years could also result in a force-out and potential taxation.

Tip: Check with your insurance agent and/or financial advisor when considering changes to your death benefit level or payment option.

How to do it

Determine your life insurance need and overall financial goals

Before you buy life insurance, you need to know how much insurance you need. Insurance need is based on numerous factors, including your current age and income, marital status, number of incomes in the household, number of dependents, long-term financial goals, level of outstanding debt, and existing insurance and other assets. Your overall financial, estate, and tax-planning goals and your planning horizon should be considered as part of your insurance need evaluation. For more information on determining appropriate levels of life insurance, see How Much Is Enough?

Tip: Consult your financial advisor concerning your need for insurance. Some of the calculations can be complicated.

Complete the insurance application and name your beneficiary

Before the insurance company can issue your policy, it must receive a completed application form. The application includes general health questions, and the process may include a physical examination, which is usually paid for by the insurance company. A critical part of the application is the beneficiary designation--the naming of the person or persons to receive the policy proceeds when you die. Unless you make an irrevocable beneficiary designation, you can change the beneficiary designation by adding or removing a beneficiary or by changing the percentages of the proceeds distribution.

By paying the first periodic premium with the application, you may be "conditionally insured" until a policy is issued. The "condition" is that you are insurable!

Buy the policy and pay your premium

It is all well and good to know how much insurance and what type of policy is appropriate for your particular situation. But if you don't actually buy the policy, you haven't accomplished your goal! Not only that, insurance becomes more expensive with age, so you won't be doing your wallet any favors by delaying. An additional risk of delaying is that your health could change adversely. In other words, just because you are healthy and insurable today doesn't mean you will be that way later. Deterioration in your health can mean higher premiums or an insurer considering you to be uninsurable.

Choose a death benefit option

When you buy your universal life policy, you must choose a death benefit amount and option, either of which may be changed at any time. Option A (or option I) pays a level death benefit, while option B (or option II) has an increasing death benefit.

Review your insurance need periodically

The amount of life insurance you need may change over time and with the occurrence of lifetime events. As a result, you should periodically review your life insurance coverage. As a rule, you should review your coverage every three years. Major lifetime events (such as the purchase of a home, birth or adoption of a child, and a change in marital status) are also appropriate times to review your coverage. By routinely checking your insurance need, you can prevent the mistake you can't fix after you die: not having enough life insurance.

Change your premium amounts and/or death benefit as desired

After you have paid your initial premium, you may be allowed to increase or decrease the amount of your premiums. You may even be able to skip premiums, as long as your cash value account has a sufficient balance to cover the cost of insurance and any expenses. Generally, you can change your payment option and/or premium amount at any time to meet your changing need for insurance coverage and without notifying the insurance company in advance. You can also change your death benefit by notifying the insurance company.

Tax considerations

Income Tax

Premium payments not deductible

Life insurance premium payments are generally not tax-deductible expenses.

Policy loan proceeds generally not taxable

When you take out a loan against your life insurance policy (except a policy classified as an MEC), the amount you receive is not considered taxable income. This rule applies even when the loan is larger than the amount of premiums you have paid in (except in the case of a policy classified as a MEC).

Example(s): You own a life insurance policy (non-MEC) with a cash value of \$20,000. Your basis in the policy is \$14,000. You decide to take a policy loan to pay your daughter's college tuition. Under the terms of your policy, you are allowed to take a loan for an amount up to 90 percent of the policy cash value--in this case, \$18,000 ($\$20,000 \times .90$). You are not currently subject to tax on the amount of the loan, even though the loan is larger than your basis.

Caution: If you cancel your policy while there is a loan balance outstanding, you could be subject to income tax on the amount of the loan (plus any accrued but unpaid interest).

Policy loan interest not deductible

Interest you pay on a policy loan is not a tax-deductible expense when the loan is for purposes other than business or investments.

Policy cancellation may be taxable

If you cancel (surrender) your policy for cash, the gain on the policy is subject to federal income tax. The gain on a canceled policy is the difference between the net cash value and loan forgiveness amounts and your policy basis.

Caution: You may be subject to surrender charges, which are often in effect for 10 to 15 years on a universal life policy. Check your policy.

Caution: Policy fees and expenses are usually charged against the policy in the first few years. As a result, policy surrenders during the first few years of the policy may provide little cash value.

Caution: If you surrender your policy while there is a loan balance outstanding, you could be subject to income tax on the amount of the loan (plus any accrued but unpaid interest).

Policy lapse may be taxable

If you allow your policy to lapse, you could be subject to income tax even if you don't receive any cash from the policy as a result of a lapse. A policy lapse can occur when you stop paying premiums and don't have cash values available that can be used to pay the premiums. If you have an outstanding policy loan, it is possible you could be subject to tax on the amount of the loan plus any accrued interest.

Increasing your premium amount could result in income tax consequences

If you choose to increase the amount of the premiums you pay or make additional premium payments on your universal policy (especially during the first seven years), it is possible that the cash value could become excessive relative to the death benefit. This could cause the policy to be classified as an MEC for income tax purposes. Distributions and policy loans from MECs are subject to unfavorable income tax treatment. In addition, penalties may apply to distributions and policy loans from MECs if taken before age 59½.

Death benefits generally not subject to federal income tax

Policy death benefits are generally not subject to federal income tax. One notable exception is when the policy has been sold or otherwise transferred for valuable consideration by one policy owner to another, subjecting it to the transfer-for-value rule.

Gift and Estate Tax***Policy proceeds not considered gift to beneficiary***

When the proceeds of your life insurance policy are paid to a beneficiary, they are not treated as a gift for gift tax purposes.

Policy premium payments generally not subject to gift tax

When you are the owner of a policy on your own life, with another party as the beneficiary, premium payments made by you are not considered a gift to the beneficiary for gift tax purposes. If, however, someone else pays the premiums on a policy you own, the premium payments are considered a gift to you and may be subject to gift tax. However, policy premiums paid by another on your behalf generally qualify for the annual gift tax exclusion.

Policy proceeds included in estate value in some cases

The proceeds of a life insurance policy are included in the value of your estate if you held any incidents of ownership at any time during the three years before your death or if the proceeds are payable to you or your estate or executor. Incidents of ownership include (among other things) the right to change the beneficiary, take out policy loans, or surrender the policy for cash.

Policy proceeds often exempt from state inheritance taxes

In many states, life insurance proceeds are exempt from state inheritance taxes.

Questions & Answers***If you are covered under a group life insurance policy through your employer, do you still need a personal policy?***

Yes, you should have your own policy outside the group coverage provided by your employer. The policy through your current employer is more than likely not portable--meaning that when you leave the company, your life insurance coverage will not go with you. It is very common for people to change jobs numerous times during their career. Even if you plan to stay with your current job until retirement (assuming your job exists that long), what will you have for coverage afterward? The best way to make sure your family is provided for when you die is to have your own insurance coverage in addition to any provided by your employer. While conversion coverage may be available, it may be expensive and it may offer limited coverage. In addition, it may not meet all of your coverage needs.

Can your spouse own a policy on your life and name your child as beneficiary?

This can be done, but it shouldn't be. When the insured, the policyowner, and the beneficiary are three different parties (sometimes referred to as the "unholy trinity" or the "Bermuda triangle"), the death benefit may be subject to gift tax.

Can you name your spouse as the beneficiary on your life insurance policy if he or she is not a U.S. citizen?

You can, but there could be estate tax consequences. When your spouse isn't a U.S. citizen and is the beneficiary on your life insurance policy, the death benefit isn't protected by the unlimited marital deduction.

Should you buy life insurance on your children?

In some instances it is advisable to buy life insurance on your children, but it shouldn't be done until the appropriate levels of coverage are in place on the lives of the family breadwinner(s) and a non-wage-earning spouse engaged in the care of the children.

Should you buy term insurance or cash value life insurance?

It depends upon your personal circumstances. The first issue to resolve is not what type, but how much life insurance you should buy, and how long your coverage is needed. Once you can answer the quantifiable insurance question, you can move on to the financial aspect. It is possible that the amount of coverage you need is so large that the only affordable way to get the coverage is with lower-premium term insurance. If you can afford the needed coverage with either type of policy, then you should think about the financial aspect of which type of policy to buy, considering such factors as your tax bracket and the rate of return you could receive on alternative, similar risk investments.

With cash value life insurance, does your beneficiary get the death benefit plus the cash value amount?

Maybe. Check the policy. Many cash value policies are written in such a way that the beneficiary receives only

the face amount of the policy at death. The cash value is applied to partially pay off the death benefit. There are policies that will pay the beneficiary the face amount plus the cash value, but the premiums tend to be higher. Don't just assume that your policy will pay both amounts--check the policy and/or ask your agent.

Should you "invest" in insurance?

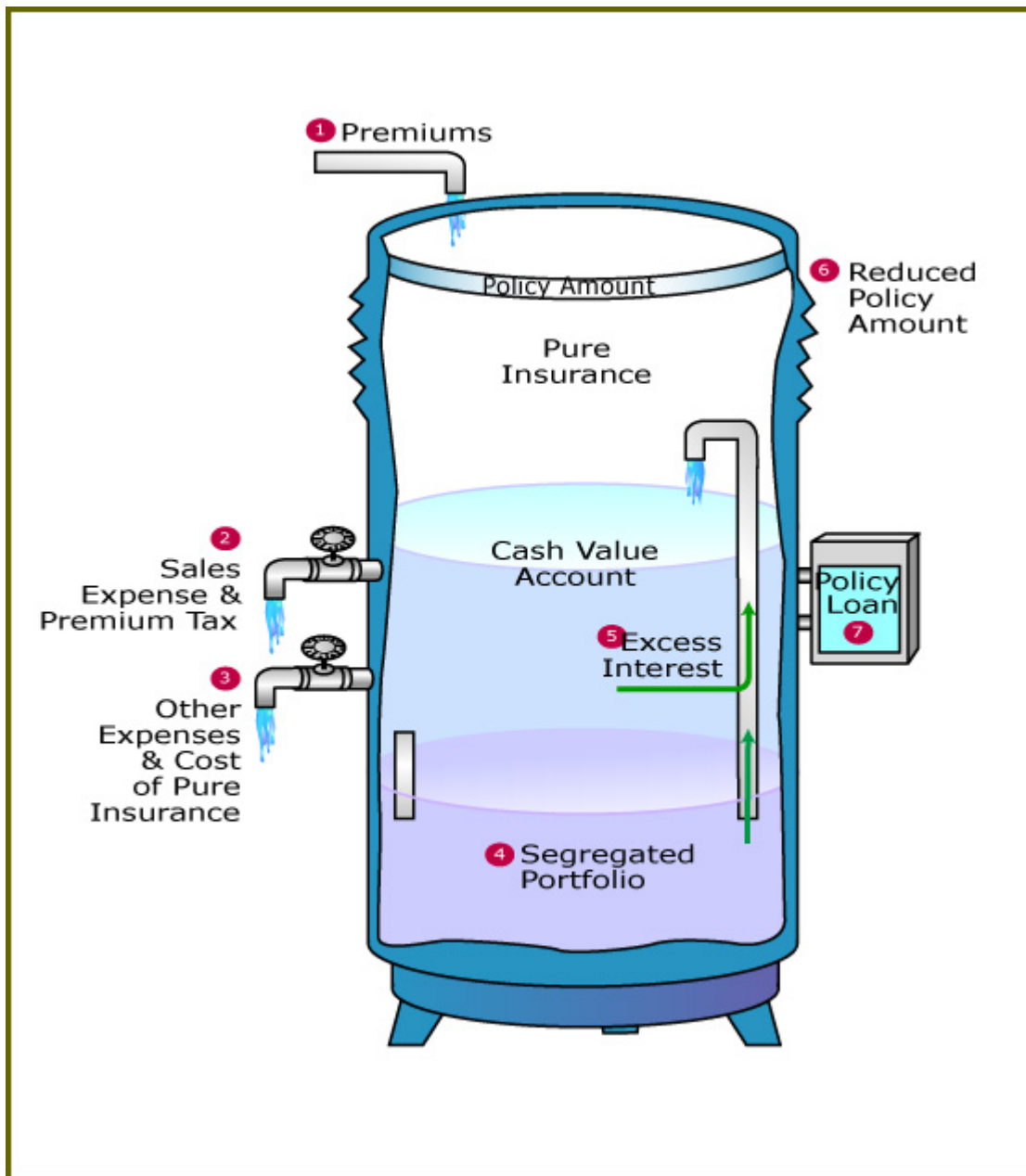
One of the benefits of cash value life insurance, such as universal life insurance, is the opportunity for cash value growth. The cash value can be used for retirement income, education expenses, or for many other purposes. However, in most cases, the primary purpose of purchasing cash value life insurance should be for the permanent death benefit it provides.

What is the difference between universal life insurance and traditional whole life insurance?

Both are types of cash value life insurance, but there are important differences between the two. Generally, whole life is designed with fixed, level premiums and provides for a level death benefit. Some flexibility is provided, however, through dividends paid on participating policies that can be used to offset premiums or increase the death benefit, thus creating a degree of flexibility. Universal life policies, by design, offer adjustable death benefits and flexible premiums that can be changed.

Another big difference is the reporting of the policy elements in a universal life policy. Unlike many other types of cash value policies, universal life policies are divided into three elements--protection, expense, and cash value. This unbundling of the policy elements allows you to see the specific charges for each component of your policy, which makes it easier to read reports on your in-force policy and could make it easier when comparing universal policies from different insurance companies.

How Universal Life Insurance Works



1. You decide (up to limits regulated by federal tax law) when and how much premium payment to "pour in." The minimum premium is based on insurance company expenses, premium taxes, and the cost of pure insurance for your policy.
2. As you pay your premium, the insurance company deducts its sales expenses and premium taxes.
3. The remainder of your premium is credited to your cash value account. Each month, the company charges this account for its other expenses and the cost of pure insurance (net amount of risk coverage), or mortality cost.
4. Your cash value earns interest at a rate that fluctuates based on the rates earned by a segregated portfolio within the insurance company's general account. A minimum (guaranteed) interest rate will be stated in your policy.
5. If the company's portfolio earns more than the guaranteed interest rate, the company credits the excess interest to your policy.

6. If your remaining cash value is not sufficient to cover expenses and the cost of pure insurance, and you do not pour in more premium, the policy amount may then have to be reduced, or your policy will lapse. This would be similar to crushing the container at the top.
7. You may take a policy loan in an amount not to exceed the policy's cash surrender value less the annual loan interest. Repayment replenishes your cash value; any loan balance outstanding (plus interest due) at your death is deducted from the policy amount paid to your beneficiary.

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