CHAPTER 4 Life Insurance Structure, Concepts, and Planning Strategies

**Where can you make a living as a financial planner?**

1) **Wealthy clients have a much higher profit margin. The challenge is that there just are not many of them. And they are extremely hands on and high maintenance.**

2) **Middle income clients have fewer less complicated financial issues. The profit margin per client is typically lower. They are interested in only a few things:**

    1) **How do I protect myself, my family, and my assets?**

    2) **How do I get out of debt?**

    3) **How do I save for retirement?**

    4) **How can I get my kids to college?**

## Personal Risk Management: An Overview

**Three steps to managing risk**

1. **Identify nature and cause of the risk**
2. **Determine how much if any risk you are willing to assume**
3. **Determine the best technique for handling the risk**

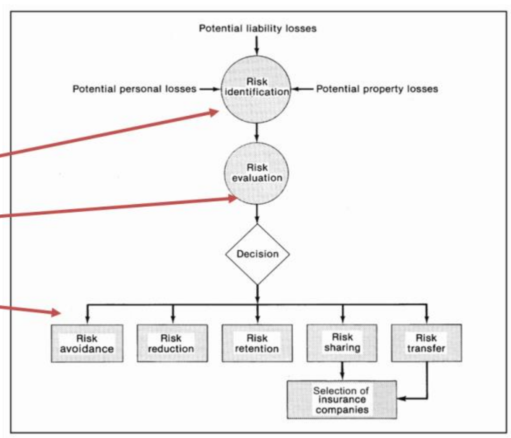



FIGURE 4-1 Personal risk management: an overview

**The picture illustrates the basics of risk management:**

1) **You must be able to identify the risk.**

2) **You must then determine how much of the risk you are willing to assume.**

3) **In the end you then must decide what technique to use to manage the risk you are not willing to manage.**

THEORY OF RISK TRANSFER:  HANDLING RISK

What is Risk Avoidance?

**Not do the activity**

Risk Retention?

**Absorb the risk**

Risk Reduction?

**Deductibles**

**Resale of insurance**

Risk Sharing?

**deductibles**

Risk Transfer?

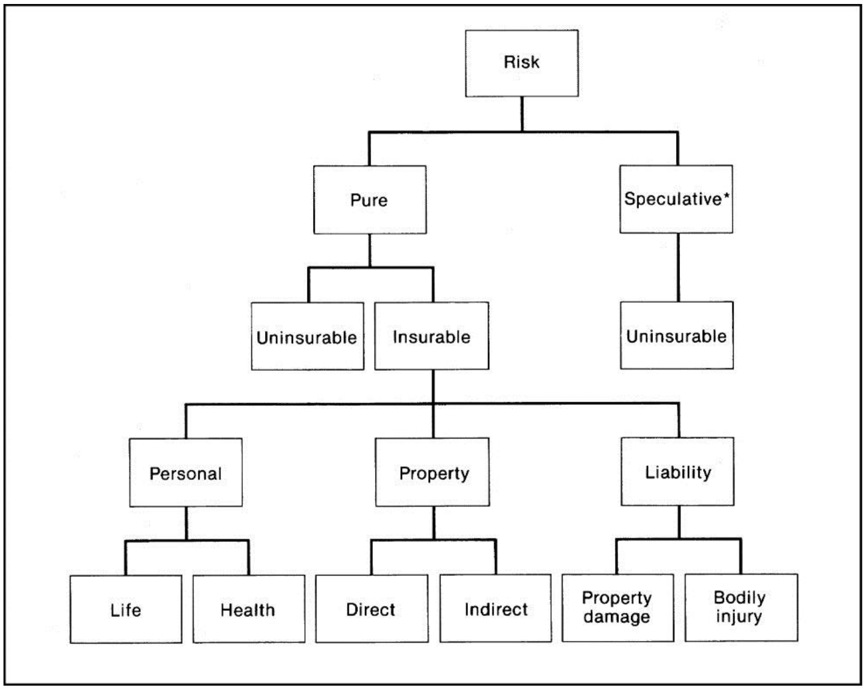
**Insurance**

**hedging**

**TABLE 4-2** Various Ways of Handling Risk

| | High Frequency | Low Frequency |
|---|---|---|
| High Severity | Avoidence | Transfer/Sharing |
| Low Severity | Reduction | Retention/Sharing |

Types of Insurance Available




* A speculative risk is one in which there is a chance of either loss or gain. Starting a business and gambling are examples of speculative risk.

**FIGURE 4-2** Types of Insurance Available for Certain Risks Adapted from David L. Bickelhanpt, General Insurance, 11th ed. (Homewood, Ill.: Richard D. Irwin, 1979), p. 11, copyright 1983, Richard D. Irwin, Inc.

**Can you insure gambling losses?**

**Can you insure stock losses?**

**Can you insure against bad business decisions?**

Life Insurance : INTRODUCTION

**What are the primary reasons for personal life insurance?**

**Replace lost income**

**Assist a family in maintaining a level of quality of life**

**What could this be?**

**Assist businesses to continue after the loss of a key person or owner**

In Purchasing Life Insurance:

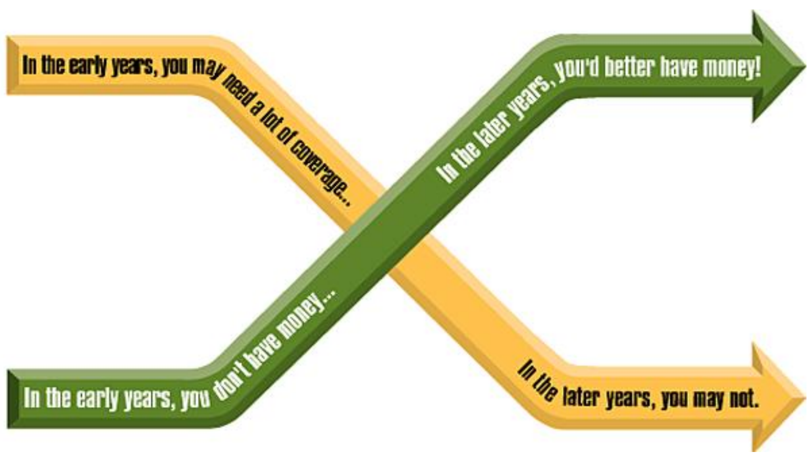
Main objectives are to determine how much insurance to purchase, and which type of insurance offers best value.

Secondary objective is to treat life insurance as a form of savings.

Very poor investment vehicles

| |
|---|
| What do we want insurance to do? |

Theory of Decreasing Responsibility (Byerly)




| |
|---|
| This theory was developed to illustrate the need for protection for a family. IN early years people have many responsibilities but in the case of death of a bread-winner, no cash to pay for the lost income.<br><br>As a person gets older, the responsibilities of life leave. At retirement the need is for cash. As we will find out, life insurance can not payout more than it's face value. Then it only pays that off at death. Where will the money come from to live during retirement? |

How does life insurance work?

http://www.youtube.com/watch?v=VzhsZHTdZag&feature=player_detailpage&list=PLQcenk-Mor852srKdlBkJobvU5U_EnFFb

Dave Ramsey on Life Insurance

http://www.youtube.com/watch?v=gvjir8yxPUI&feature=player_detailpage&list=PLQcenk-Mor852srKdlBkJobvU5U_EnFFb

Describe Term Insurance

**What is the simplest definition of term life?**

What is Credit life insurance?

**Covers if a person dies and owes a debt**

| |
|---|
| What is cash value? A policy that does more than one thing at a time.<br><br>1) It insures against death? Not really. It replaces income.<br><br>2) It earns a return on an investment.<br><br>The important questions are:<br><br>1) Will it pay If I die? Assuming the company has good financial soundness and the company pays quickly, this is good.<br><br>2) Does the investment piece work? This is the piece that does not work.<br><br>Would it be better to be able to buy more insurance for the same amount or the right amount for less and also to have an investment that grows at a decent pace? |

How does a Loan work with life insurance?

**Obtain the funds**

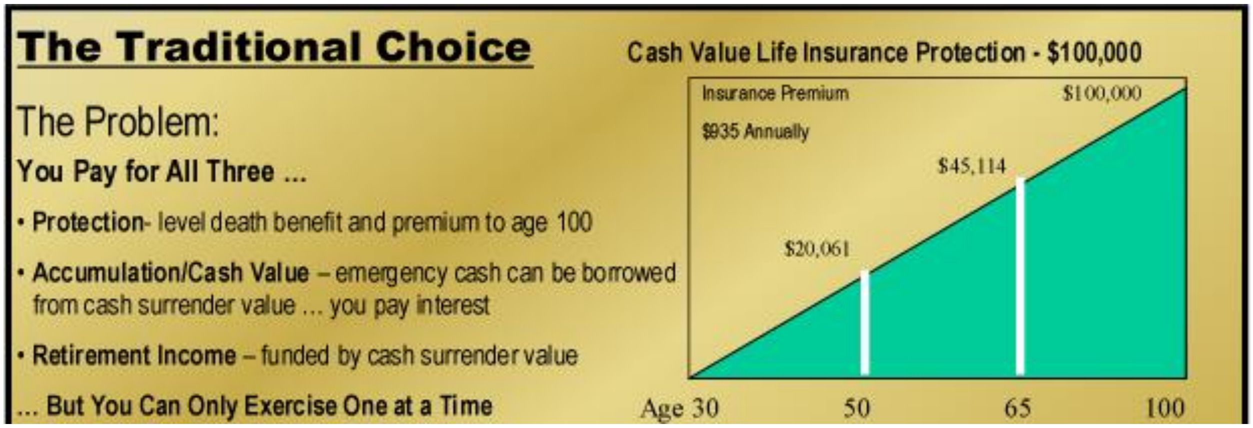
**Do you need to pay it back?**

**Do you pay interest? Who gets it?**

What is meant by “Buy term and Invest the difference”?

**In the following example we can make this clear.**

Cash Value Policies




This is an example of how a whole life policy works.

This represents a $100K policy. The cost is $935 per year.

The concept is simple; you are buying 3 things but can only do one at a time.

1) You will be protected to age $100.
2) You are building a savings piece.
3) You are accumulating a retirement amount.
4) The challenge is you can only do one at a time. Using any of the options either eliminates or reduces the others.

Questions:

1) At 65 if you die, what do you receive? (100K) Where did the money come from? (45K from your cash value; the ins company only pays 54K) Whole life in essence is self insurance.
2) What happens at age 100? (the policy endows and the company pays you $100K)

The following slides have been gathered over the past several years. The goal is to illustrate the characteristics of whole life policies. (Byerly)

## The Four Funny Banking Rules

**Common Attributes of Cash Value Insurance Policies**

No investment gain for first 1 – 3 years

1% to 4% return on your money

6% to 8% to borrow your money

Keeps all cash if you die (in most cases)

The essence of this slide considers the investment aspect of cash value.

If I were to offer you the following opportunity, would you take it?

1) I will keep your money for the first 1 to 3 years, you will not have access.

2) I will give you between 1 & 4% return on your money.

3) If you want to borrow, I will have to charge you from 6 -8 % to borrow your own money.

4) If you should die, I would keep all your money (or at least most of it)

Is this a good investment vehicle?

BENEFITS AND PREMIUMS
DATE OF ISSUE MAY 21, 1998

| PLAN AND ADDITIONAL BENEFITS | AMOUNT | ANNUAL PREMIUM | PAYABLE FOR |
|---|---|---|---|
| EXTRA ORDINARY WHOLE LIFE | | $ 417.20 | LIFE |
| BASIC AMOUNT | $36,000 | | |
| EXTRA LIFE PROTECTION | 24,000* | | |
| TOTAL INSURANCE | 60,000 | | |
| WAIVER OF PREMIUM | | 9.00 | 39 YEARS |
| INDEXED PROTECTION | | 15.00 | 10 YEARS |
| WAIVER OF PREMIUM | | 3.60 | 10 YEARS |

* THIS AMOUNT OF EXTRA LIFE PROTECTION IS GUARANTEED FOR THE FIRST 32 POLICY YEARS UNLESS THIS GUARANTEED PERIOD IS TERMINATED SOONER UNDER SECTION 1.3.

A PREMIUM IS PAYABLE ON THE POLICY DATE AND.EVERY 12 POLICY MONTHS THEREAFTER.

THE FIRST PREMIUM IS $444.80.

THIS POLICY IS ISSUED IN A SELECT PREMIUM CLASS.

DIRECT BENEFICIARY xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx

OWNER xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx

INSURED xxxxxxxxxxxxxxxxxxxx AGE;AND SEX 26 FEMALE

'POLICY DATE MAY 21, 1998 POLICY NUMBER 9 587 988

PLAN EXTRA ORDINARY WHOLE LIFE

| | |
|---|---|
| BASIC AMOUNT | $ 36,000 |
| EXTRA LIFE PROTECTION | 24,000 |
| TOTAL INSURANCE | 60,000 |

This a policy for a 26 year old female. Total coverage $60K

The cost is 444 per year. The policy has basic protection and extra life protection. What is extra life protection?? I don’t know.

The policy classification is select premium. What is that?

TABLE OF GUARANTEED VALUES

| POLICY YEAR | MAY 21, | CASH VALUE | PAID-UP INSURANCE | EXTENDED TERM INSURANCE TO |
|---|---|---|---|---|
| 1 | 1998 | $ ***0*** | $ 0 | |
| 2 | 1999 | ***0*** | 720 | OCT 22, 2000 |
| 3 | 2000 | ***440*** | 2,304 | JAN 12, 2005 |
| 4 | 2001 | **754** | 3,816 | MAY 15, 2009 |
| 5 | 2002 | 1,082 | 5,292 | JUN 15, 2013 |
| 6 | 2003 | 1,423 | 6,732 | APR 26, 2017 |
| 7 | 2004 | 1,778 | 8,100 | JUL 19, 2020 |
| 8 | 2005 | 2,148 | 9,432 | APR 15, 2023 |
| 9 | 2006 | 2,532 | 10,764 | AUG 26, 2025 |
| 10 | 2007 | 2,931 | 11,988 | SEP 25, 2027 |
| 11 | 2008 | 3,322 | 13,104 | JUN 27, 2029 |
| 12 | 2009 | 3,727 | 14,184 | JAN 27, 2031 |
| 13 | 2010 | 4,143 | 15,228 | JUL 9, 2032 |
| 14 | 2011 | 4,573 | 16,236 | NOV 8, 2033 |
| 15 | 2012 | 5,014 | 17,172 | FEB 2, 2035 |
| 16 | 2013 | 5,467 | 18,108 | MAR 29, 2036 |
| 17 | 2014 | 5,932 | 18,972 | APR 25, 2037 |
| 18 | 2015 | 6,408 | 19,800 | APR 28, 2038 |
| 19 | 2016 | 6,897 | 20,592 | APR 9, 2039 |
| 20 | 2017 | 7,397 | 21,348 | MAR 2, 2040 |
| AGE-60 | 2031 | 15,359 | 29,052 | AUG 28, 2048 |
| AGE 65 | 2036 | 18,422 | 30,780 | APR 29, 2051 |
| AGE 70 | 2041 | 21,384 | 32,112 | DEC 2, 2053 |

| | | | | | |
|---|---|---|---|---|---|
| INSURED | xxxxxxxxxxxxxxxxxx | AGE AND SEX | 26 FEMALE | | |
| POLICY DATE | MAY 21, 1998 | | POLICY NUMBER | 9 587 988 | |
| PLAN | EXTRA ORDINARY WHOLE LIFE | | BASIC AMOUNT | $ | 36,000 |
| | | | EXTRA LIFE PROTECTION | | 24,000 |
| | | | TOTAL INSURANCE | | 60,000 |



This page is included in every contract. It specifies the expected and guaranteed cash values for the life of the policy.

1) What is the guaranteed cash value for the first 4 years? How much can you borrow?

2) How much will be in the account at age 65?

3) What rate of return would you earn? Invest 444 for 40 years and end up with 18K.
.189% If you included the paid up coverage? (48K) 4.52%

4) What is the current inflation rate? What is the real return?

5) How would you rank this as a long-term investment vehicle?

**1.1 LIFE INSURANCE BENEFIT**

The Northwestern Mutual Life Insurance Company will pay a benefit on the death of the Insured. Subject to the terms and conditions of the policy:

- payment **will** be made after proof of the death of the Insured is received at the Home Office;
- payment will be made to the beneficiary or other
- ***the amount of the benefit will be the Basic Amount shown on page 3, plus the Extra Life, Protection then in force***.

**1.2 EXTRA LIFE PROTECTION**

**Description.** Extra Life Protection consists of one year term insurance and paid-up additions. At first, it is all one year term insurance. Each dividend used to purchase paid-up additions. These additions reduce the amount of one year term insurance until Extra Life Protection is All paid-up additions. After that, dividends may be used in any way described in Section 4.2.

The amount of Extra Life Protection and the period for which it is guaranteed are shown on page 3. After that period Extra Life Protection will continue for at least that amount so long as premiums are paid when due, unless:

- the amount is reduced by the Owner under Section 1.3; or
- the amount is reduced by the Company

**Possible Reduction by Company.** After the guaranteed period, if any part of Extra Life Protection is one year term insurance, that part will be reduced if the Company finds this, is needed due to a decrease in the dividend scale. Paid up additions existing at the time of a reduction will continue. The reduced amount of Extra Life Protection will be set so that the paid-up additions to be purchased by future dividends on the scale in effect at the time of a reduction will not be less than the new amount of one year term insurance. The resulting reduction in the amount of Extra Life Protection will take effect on the next policy anniversary.

What does extra life mean?

The company uses the dividends to purchase paid-up additions. It does this until the entire extra life portion is purchased.

5.4 CASH SURRENDER

**The Owner may surrender this policy for its cash surrender value. The cash surrender value is the cash value less any policy debt. A written surrender of all claims, satisfactory to the Company,** will **be required. The date of surrender will be the date of receipt at the Home Office of the written surrender. The policy** will **terminate and the cash surrender value** will **be determined as of the date of surrender. The Company may require that the policy be sent to it.**

**The Company may defer paying the cash surrender value for up to six months of the date of surrender. If payment is deferred for 30 days or more, interest be paid on the cash surrender value at an annual effective rate of 4 1/2% from the date of surrender to ,the date of payment.**

5.5 TABLE OF GUARANTEED VALUES

**Cash values, paid-up insurance and extended term insurance are shown on page 4 for the end of the policy years indicated. These values assume that all premiums due have been paid for the number of years stated. They do not reflect paid-up additions, dividend accumulations or policy debt. Values during a policy year will reflect any portion of the year's premium paid and the time elapsed in that year.**

**Values for policy years not shown are calculated on the same basis as those on page 4. A list of these values will be furnished on request. A detailed statement of the method of calculation of all values has been filed with the insurance supervisory official of the state in which this policy is delivered. It will be' furnished on request. All issued are at least as great as those required by that state.**

5.6 BASIS OF VALUES

**The cash value for policy years not shown on Rage 4 equals the reserve calculated on the Commissioners Reserve Valuation Method. Net single premiums are based on the Commissioners 1958 Standard Ordinary Mortality Table, except that for the first ten years of any period of extended term insurance the Commissioners 1958 Extended Term Insurance Table is used.. Interest is based on an *annual effective rate of 4 1/2%.* Calculations assume the continuous payment of premiums and the immediate payment of claims.**

| |
|---|
| How can you get your money?<br><br>1) Can you surrender the policy? Sure. But the company can defer payment of up to 6 months.<br><br>What return can you expect? Guaranteed 4.5% |

**The Owner may obtain a loan from the Company in an amount that is not more than the loan value.**

**Policy Loan. The loan may be obtained on written request No loan will be made if the policy is in force as extended-term insurance. *The Company* may defer making the loan for up to six months unless. the loan is to be used to pay premiums *due the Company.***

**Premium Loan. If the premium loan provision is in effect on this policy, a loan will be made, to pay an overdue premium. If the loan value is not large enough to pay the overdue premium, a premium will be paid for any other frequency permitted by this policy for which the loan value is large enough. The Owner may elect or revoke the premium loan provision by written request received at the Home Office.**

**6.3 POLICY DEBT**

**Policy debt consists of all outstanding loans and accrued interest. It may be paid to the Company at any time.. Any policy debt will be deducted from the policy proceeds.**

***If the policy debt equals or exceeds the cash value, this policy will terminate.***
**Termination occurs 31 days after a notice has been mailed to the Owner and to any assignee on record at the Home Office.**

**6.4 LOAN INTEREST**

***Interest is payable at an annual effective rate of 8%;* The Company may establish a lower rate for any period during which a loan is outstanding.**

**Interest accrues and is payable on a daily basis from. the date of the loan on policy loans and from the premium due date on premium loans. Unpaid interest is added to the loan.**

A couple interesting paragraphs.

How long does it take to get your money for a loan? Could be up to 6 months, unless you need it to pay the premium. So for the company to get their money, no problem. If you have an emergency, you may have to wait.

What interest do you pay on the loan?

8% Do I have to pay off the n money? No you do not. What happens if I do not pay the loan off?

What happens if the loan exceeds to cash value?

## Payment When Insured Dies

When the insured dies, an amount of money, called the insurance proceeds, will be payable to the beneficiary. The insurance proceeds are the total of:

- The Face Amount of Insurance.

PLUS

- Any insurance on the insured's life which may be provided by riders to this policy.
- Any insurance bought with dividends.
- Any dividends left with us to earn interest.
- Any dividend which we may credit at death.
- Any part of a premium paid for coverage beyond the policy month in which the insured dies.

Is there
ınything
ere about
he cash
value?

MINUS

- Any premium due (not more than one month's part of the premium).
- Any policy loan and loan interest.

We will pay the insurance proceeds to the beneficiary after receipt of proof of death and a proper written claim.

## Payments During Insured's Lifetime

**Dividends**

Every year we determine an amount to be paid to our policyholders as dividends. We will determine the share, if any, for this policy and credit it as a dividend at the end of the policy year. We do not expect that any dividend on this policy will be paid until at least

You may choose to use dividends in any one of these

What is a dividend?

1. *Paid-Up Additions*-- To buy more insurance on
2. *Dividend Accumulations*-- To be left with us to earn
3. *Premium Payment*-- To be applied toward the payment of premiums. Any excess will be used to buy Paid-Up Additions.
4. *Cash*-- To be paid to you by check.

Your choice may be ~~made on the application~~ for your policy or in writing at a later date. If no choice has been made, we will provide paid-up additions unless you make a different choice within 3 months after a dividend is credited. If a dividend check has not been cashed within one year, a choice of paid-up additions will be deemed to have been made.

Two points from this page.

1) How much will your beneficiaries get paid should you die?

    1) Notice the list of payouts and pay downs.

2) What is a dividend? This is a good question. The answer is not what a person usually thinks.

## U.S. TREASURY DECISION NUMBER 1743

This question (dividends) was argued at great lengths and in full detail before the Internal Revenue Department and before Congress during the early months of 1911. The income **tax clause of the Tariff Bill of 1911 proposed an income tax on Life Insurance dividends. Representatives of companies featuring participating insurance vigorously protested against this tax.** The arguments and contentions of these companies are clearly set forth in the following quotations from UNITED STATES TREASURY DECISION NO. 1743:

"That dividends declared by participating companies **are not dividends** in a commercial sense of the word, **but are simply refunds to the policyholder of a portion of the overcharge collected**, which overcharge is merely held in trust by the company issuing the policy. Annually, or at stated periods, all, or a portion thereof, is returned to the person holding the policy...

It was vigorously contended by counsel **it was necessary, in order to secure new business, to convince the prospective policyholder of the desirability of the same, and that this commercial necessity had resulted in the companies making misrepresentations of facts as to DIVIDENDS** to prospective purchasers of insurance, and that names and designations, having a single specific meaning in the commercial world and which were therefore attractive to prospective policyholders, had been adopted to represent transactions which they now hold are entirely different from what their name implies and represents, and from which the policyholder himself believed he was receiving, and that business necessities had caused a continuance of these misnomers. It was represented that, in fact, **there were no dividends, but merely a refund of overcharges**, which, for reasons above stated, were usually referred to as dividends."

In this connection, it is interesting to note how life insurance dividends are referred to in the present Federal Income Tax Regulation 94. In article 22, on Gross Income, Regulation 94, this statement appears: **"Amounts received as return of premiums paid under life insurance, endowment, or annuity contracts, and so-called DIVIDENDS of a mutual insurance company which may be credited against the current premium, are not subject to tax"**

Here is the answer to the dividend question.

In 1911 the govt wanted to tax dividends. IN insurance industry says wait a minute. "These are not dividends like corporate dividends". These payment are a return of overcharged premiums. We just can't sell the idea of the refund unless we call it a dividend.

Therefore, there is no tax. No tax no increase in wealth. How do you think people feel about dividends?

## UNIVERSAL LIFE

There are two differences between universal and whole life policies.

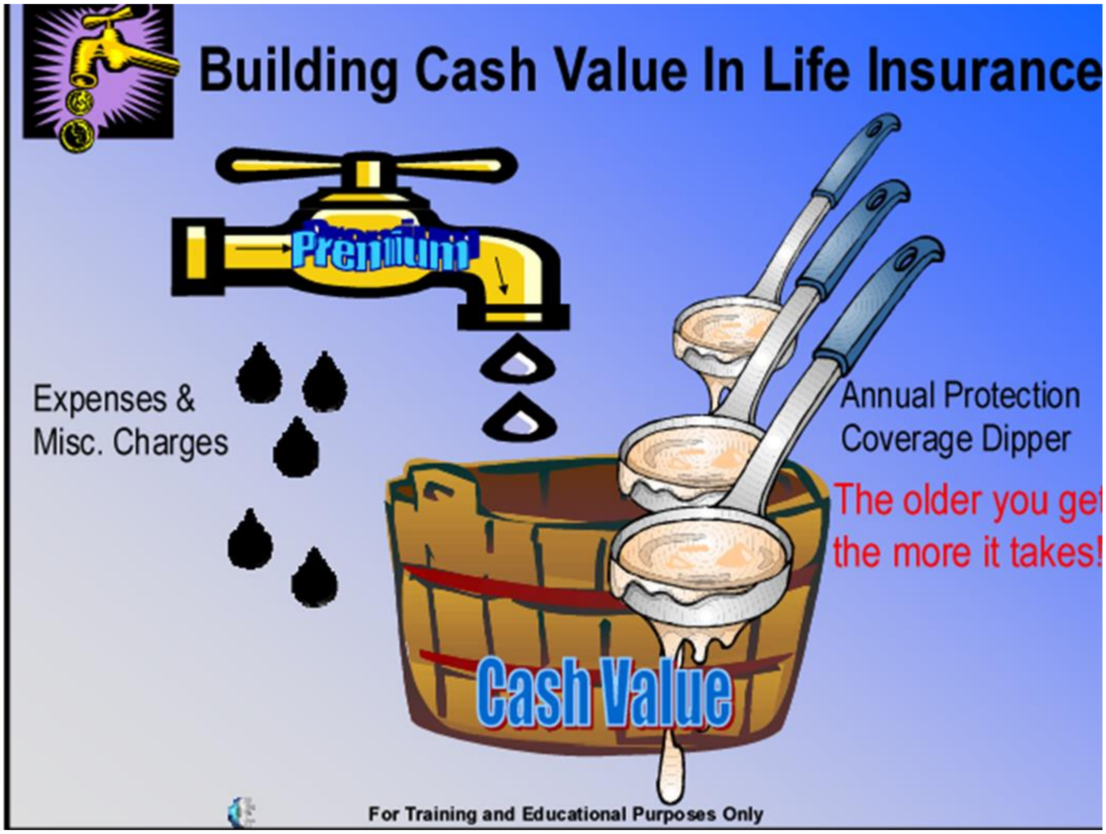
1) The investment opportunities arise from interest rates.

2) The expenses are determined differently.

3) Investment risk shifts from the insurance company to the policy holder.

4) The eventual cash value is determined by the combination of expenses and interest rates. There is usually a guaranteed value (around 4% growth).

How Universal Life Insurance Works




The illustration reflects the mechanics of how the cash value grows.

1) There is a fixed premium that "pours" into the bucket.
2) Before the premium gets to the bucket the initial expenses are withdrawn.
3) Once the remaining gets into the bucket, it has an opportunity to grow.
4) At this point the dipper represents the monthly life insurance expenses that are assed to the policy.
5) The remaining dollars in the bucket are now assessed the earnings.
6) Each year the dipper gets larger, but the premium is fixed.

Question: If the premium is fixed but the expenses increase, what has to eventually happen?

## 1. POLICY SPECIFICATIONS

Insured

Plan Medallion – Flexible Premium Variable Life

Issue Age [1] 25

Policy Number ML [redacted]

Policy Class PREFERRED NON SMOKER

Date of Issue [1] AUGUST 25, 1998

Sum Insured at Issue: $119,000

Death Benefit: Option 1 – Level Death Benefit (see section 4)

5 Year Guaranteed Death Benefit Feature: Available

**The Owner and the Beneficiary are as designated in the Application, subject to Section 19.**

**Premiums**

| | ANNUAL PREMIUMS |
|---|---|
| Target Premium | $595.00 |

**Premium 595**

**1st year Charges**

2.35% + 1.25% + 4% = 7.6%

45.22 + 240 + 96 = 381.22

(64%)

After first year

$141 (23.7%)

Does not include costs of insurance

1. POLICY SPECIFICATIONS, continued

B. Maximum Policy Charges

**Maximum Deductions from Premium Payments**

| | |
|---|---|
| State Premium Tax Charge | 2.35% of Premium |
| Federal DAC Tax Charge | 1.25% of Premium |
| Premium Charge | 4.0% of Target Premium and Rider Premium, if any, for all Policy Years |

**Maximum Deductions from Account Value**

| | |
|---|---|
| Issue Charge | $20.00 per month (will only be charged for 12 months.) |
| Maintenance Charge | $8.00 per month for all Policy Years. |

**Maximum Deferred Sales Charge [1]**

| | |
|---|---|
| Policy Year 1 | 26.00% of payments received up to one year's Target Premium |
| Policy Year 2 | 26.00% of payments received in the first Policy Year up to one year's Target Premium, plus 26.00% of payments received in the second Policy Year up to one year's Target Premium[2] |
| Policy Years 3–7 | 26.00% of payments received in the first Policy Year up to one year's Target Premium, plus 26.00% of payments received in the second Policy Year up to one year's Target Premium, plus 26.00% of payments received in the third Policy Year up to one year's Target Premium |
| Policy Year 8 | 83.33% of the 7 th Policy Year Current Deferred Sales Charge |
| Policy Year 9 | 66.67% of the 7 th Policy Year Current Deferred Sales Charge |
| Policy Year 10 | 50.00% of the 7 th Policy Year Current Deferred Sales Charge |
| Policy Year 11 | 33.33% of the 7 th Policy Year Current Deferred Sales Charge |
| Policy Year 12 | 16.67% of the 7 th Policy Y... Deferred Sales Charge |
| Policy Years 13 and after | 0 % |

**Maximum Ad...**

**During Policy Years**

1–7
8
9
10 and after

**Total Surrender Charge = $5 x 119 = $595**

For Training and Educational Purposes Only

This page represents the expenses assessed to the policy.

The first year: the top section shows some monthly charges (7.6%) of the money sent in.

The second session shows other monthly expenses. $28 per month.

This total is 381 out of the 595 premium. 64%

After the first year, some of the expense disappears. The annual expense percentage is now 23%.

This does not include the monthly life insurance expenses.

**4. DEATH BENEFIT**

The Death Benefit is payable when the Insured dies while the policy is in full force. The Death Benefit will equal the death benefit of the policy minus any indebtedness on the date of death. If the Insured dies during a Policy Grace Period as described in Section 8B, we will also deduct the amount of any unpaid charges as defined in Section 10.

The death benefit of the policy depends on which of the following Options is selected at the time the policy is issued. The determination of the death benefit under each of these Options will be affected by withdrawals as described in Section 12:

**Option 1: Level Death Benefit:** The death benefit of the policy is the greater of: (i) the Sum Insured; and (ii) the Account Value on the date of death times the applicable Corridor Factor shown in Section 2.

**Option 2: Variable Death Benefit:** The death benefit of the policy is the greater of: (i) the Sum Insured plus the Account Value on the Date of Death; and (ii) the Account Value on the Date of Death times the applicable Corridor Factor shown in Section 2.

**Option 3: Level Death Benefit with Greater Funding:** The death benefit of the policy is the greater of: (i) the Sum Insured; and (ii) the Account Value on the Date of Death times the applicable Death Benefit Factor shown in Section 2.

You may change between death benefit options 1 and 2 after issue, subject to our administrative rules then in effect. However, you may not change to or from option 3.

How is the death benefit paid?

Which way do you want the beneficiaries to get paid?
Who are the beneficiaries?

Other Life Insurance Policies

VARIABLE LIFE

Additional expenses for mutual fund fees

LIFE INSURANCE FOR INDIVIDUAL FAMILY MEMBERS

Spousal Insurance

**Important even if non-working spouse**

**Why?**

Insurance for Children

**Why?**

**How much?**

GROUP LIFE INSURANCE

Any amount over $50,000 paid by the company is taxable

CAFETERIA PLANS

Menu of choices made by the employee to best fit their needs

LIFE INSURANCE RIDERS

**LIFE INSURANCE RIDERS**

| *Title* | *Explanation* |
|---|---|
| Multiple Indemnity | This clause provides a doubling or tripling of the face amount if death results from certain specified causes, such as an accident. |
| Waiver of Premium Benefit | If the policyholder becomes totally or permanently disabled, the insurance will remain in force without further premium payments. There is usually a six month waiting or elimination period before this benefit becomes applicable. In a permanent policy, the cash value grows just as if the premiums are still being paid, and the insured is allowed to borrow against the cash value in the policy. Furthermore, in the case of a universal life policy, only the mortality costs are covered. |
| Guaranteed Insurability Rider | This rider guarantees that, up to the specified age, additional life insurance can be bought on certain "option dates" without proving insurability. |
| Accidental Death and Dismemberment | This rider provides benefits for loss of limb, eye, or death by accident. |
| Disability Income Rider | This rider provides a monthly income to the insured upon becoming disabled. |

What is a rider??

What is a rider? An additional insurance contract within the contract.

Of course, most companies charge for these. Is the cost worth the contract?

Waiver of premium is a policy that will continue premium payments should the policy holder become sick or for some reason cannot make the payments. Sometimes loss of job will qualify, but not always.

Terminal illness rider provides funds to a policy holder that becomes terminally ill. Essentially it works like a loan. But the policy pay off is reduced. This can be very important to a family in a time of need. Unlike other riders, this rider should not be charged. Since the insurance company does nothing until the date, and then they are paid for the loan, they should not charge.

Life Insurance Contract Terms

- What do these terms mean?
  - Incontestability
    - **Cannot deny coverage for statements made on application**
  - Grace period
    - **Policy will not lapse due to non-payment**
  - Additional coverage purchased with dividends
    - **The client tells the insurance company to keep the dividends and use them to buy more coverage, usually term.**
  - Ownership clause
    - Who owns? What does this mean?
      - **Who determines the beneficiaries**
      - **Who will have the policy as part of their estate?**

Taxation, and Switching

- TAXATION OF LIFE INSURANCE
  - Distribution upon Death
    - **Tax free to beneficiary**
  - Distribution during Life
    - **Dividends?**
    - **Loans?**
    - **Surrender?**

- LIFE INSURANCE AND ESTATE TAXES
  - Who owns the policy?
  - Usually the primary insured
  - Could be a company

SWITCHING LIFE INSURANCE POLICIES

Replacement should be watched carefully

**The insurance industry is very protective of its profits.**

**Converting from one CV to another is not seen as a threat**

**Regulators see this as a sign of possible churning**

**Converting from CV to term is the threat.**

**Must provide additional paperwork.**

RATINGS OF INSURANCE COMPANIES

Why is this important?

DETERMINATION OF LIFE INSURANCE NEEDS

Two Time-tested Methods:

Human Value Approach

Based on Client's Income Potential

Capital Needs Analysis

Sufficient for Covering Family's Economic needs

There are two basic approaches to determining how much life insurance you need.

1) The human value approach assesses some increment or multiple to a person's income. This is where we get the rule of thumb: you need 6 to 10 times your income in life insurance.

    1) Think about how much you need. What would this cost in whole life or universal life?

2) The capital needs approach looks at expected needs for the funds. What could the family need in the future. While this seems like a very difficult process, remember the theory of decreasing responsibility. We do not need insurance forever.

Expense Needs Versus Sources of Income

**Look at sources of income? This is all that is left.**

**TABLE 4-6** Expense Needs Versus Sources of Income

| *Expense Needs* | *Sources of Income* |
|---|---|
| A. Single-Period Needs | A. Social Security: Survivor's Income |
| i. Administrative/Final Expenses* | B. Group Life Insurance |
| ii. Estate Settlement Costs* | C. Spouse's Earnings |
| iii. Debt Liquidation* | D. Investment Income |
| iv. Emergency Fund* | |
| B. Multiple-Period Needs | |
| i. Educational Cost | |
| ii. Surviving Spouse's Income Needs | |
| iii. Children's Income Needs | |
| iv. Retirement Needs | |

* Life insurance does not necessarily need to cover these expenses. These items should be considered optional in determining the life insurance needs of a family.

The cash flows associated with death benefits can be segmented into things you need immediately and things you will need for longer periods of time.

1) Single period needs primarily deal with the costs of death and the emergency funds needed until the family can sort out their lives.

2) The multiple period needs are the long-term challenges that occur when a bread-winner passes away.

Just as important is the question of where does the money come from?

After death the funds available to the family change.

1) The remaining spouse will have an income or will may need to get one. But this is not money available in the short term for expenses.

2) The deceased person's company may have provided some group life insurance. When this is available is a question.

3) Investment income can ultimately be used to fund some of these needs. I wonder how much investment income there will actually be. We know that most people do not save a lot of money. Are they referring to retirement funds? This may be needed for the remaining spouses retirement.

Determination of Life Insurance Need

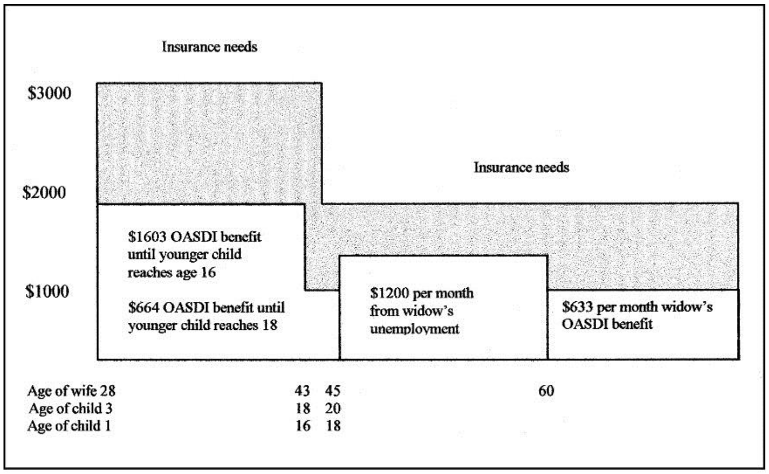



**FIGURE 4-6** Determination of Life Insurance Need

This table just reflects that there is always a need for coverage. Unless the family is very wealthy, there will seldom be enough income to cover all the future needs of the family.

**The textbook example and workout of the amount of insurance needed is difficult to follow. There are 5 basic questions that need answered.**

**Payoff mortgage?**

**Payoff debt?**

**Pay for kids education?**

**Pay for final death expenses?**

**Monthly income to replace?**

Very simple questions to fulfill the answer to the question of how much do I need?

1) Do you want the funds to pay off the mortgage? Probably the biggest worry of the remaining family.

2) Would you like the funds to payoff any or all of the consumer debt of the family.

3) Would you like to have some funds available for your children's college education? Private primary education?

4) Would you like to cover the final expenses from your death?

5) Would you need to replace any income that is now lost? This is actually the hardest question. The end answer depends on the answers above. If everything is paid off, we probably do not need all of the decedent's income. See the worksheet on the next slide to understand the process.

Ask the client (primary) what would you want the insurance to cover if the spouse died? (fill in under spouse column). Ask the spouse what they want the insurance to cover should their spouse die, fill in under primary. Life insurance needs worksheet

| | | | Primary | Spouse |
|---|---|---|---|---|
| **enter yes or no** | | | | |
| **Payoff Mortgage?** | | | yes | yes |
| | **Amount?** | $175,000 | | |
| **Payoff Debt?** | | | yes | no |
| | **Amount?** | $45,000 | | |
| **Pay children's education?** | | | yes | no |
| | **Amount?** | $25,000 | | |
| **Pay final expenses?** | | | yes | yes |
| | **Amount?** | $15,000 | | |
| **monthly income?** | | | **Primary** | **Spouse** |
| | | **amount?** | $2,925 | $1,600 |
| | | **time?** | $12 | $12 |
| | | **return?** | 8.00% | 8.00% |

| **Amount of monthly income needed?** | | | **Primary** | **Spouse** |
|---|---|---|---|---|
| | **enter amounts** | | | |
| **net income?** | | | $4,500 | $2,500 |
| **mortgage expenses? (if paid off with Ins)** | | | $1,400 | $1,400 |
| **Debt expenses? (if paid off with ins)** | | | $900 | $0 |
| **amount save for education?** | | | $75 | $0 |
| **change in child care costs?** | | | $500 | $500 |
| **any other changes in expenses?** | | | $300 | $0 |
| **minimum needed to replace income** | | | $2,925 | $1,600 |

| **Coverage needed** | | |
|---|---|---|
| | **Primary** | **Spouse** |
| **Mortgage** | $175,000 | $175,000 |
| **Debt** | $45,000 | $0 |
| **Education** | $25,000 | $0 |
| **Final expenses** | $15,000 | $15,000 |
| **Monthly Income** | $270,220 | $147,812 |
| **Approx. amt of ins needed** | $530,220 | $337,812 |
| **Current Insurance Coverage** | $150,000 | $80,000 |
| **Insurance Shortfall** | -$380,220 | -$257,812 |

The first four questions are the easiest. Each person is asked how they want the final expenses to be paid. That is the primary policy holder answers question for the funds from the spouses death benefit.

The bottom portion helps to address the last question.

We start with the income of each person and then subtract the payments for the responsibilities that are now covered.

The end balance reflects not just the total amount needed but the amount of insurance needed to cover any potential shortfalls.

## LOANS FROM LIFE INSURANCE POLICY

What happens when a person borrows from a policy?

1) You do not need to pay back the loan, but you must pay the interest. The interest owed is to the insurance company. They will take this from the cash value if it is not paid.

2) Of course it reduces the death benefit should the policy holder pass away.

3) There is a test to determine whether the loan amount is ultimately taxable.

In the end there are far more desirable methods of borrowing.

## LIFE INSURANCE SETTLEMENT OPTIONS

### Basic Considerations

**Will the original intent be followed**

**After distribution control goes to the beneficiary**

### Distribution

Lump-Sum Payment: Tax-Free

Fixed Annuity: Partially Taxable

"annuitization"

In the end the question that concerns policy holders is what will happen to the funds once I am gone? What choices are available for the beneficiary to choose from. Unless the distribution is ultimately provided to the beneficiary via a trust. They get to choose.

Lump sum: Get it all ; no taxes ; challenge is what to do with that money.

Annuitization

What is it?

**Convert a lump sum into "guaranteed" payments for time certain.**

**What does time certain mean?**

PMT for Life

What if die in 3 years

Insurance company keeps the rest

Period certain

The insurance company guarantees a certain # of payments

10 year certain

If die in 15 years the insurance company pays until you die

If die in 5 years, the insurance company would pay to a beneficiary the amount that would have been received for 10 years, the insurance company would keep any excess

They can also choose annuitization. Annuitization is the process of converting a lump sum amount into a set of equal cash flows.

The challenge of annuitization is that the client gives up control of the funds. The essentially create a contract with the insurance company to receive the cash flows with guarantees of the agreement.

Life-income option – The insurance company establishes the expected life span of the beneficiary and then agrees to pay for the rest of the persons life. For instance, the company agrees to pay $3,000 per month from a $1,000,000 benefit for the rest of the person's life.

What if the person lives for 100 years? They pay for 100 years.

What if the person dies in 5 years (balance now 900,000 balance)? The insurance company keeps the remaining balance.

What about the 20 year option? Same results.

Variable Annuity Option

Same as fixed annuity with different investment options

Investment risk falls to the policy holder and away from the insurance company

There is controversy here?

Suitability

Capital gains are converted to ordinary income

How a Life Insurance Trust Works

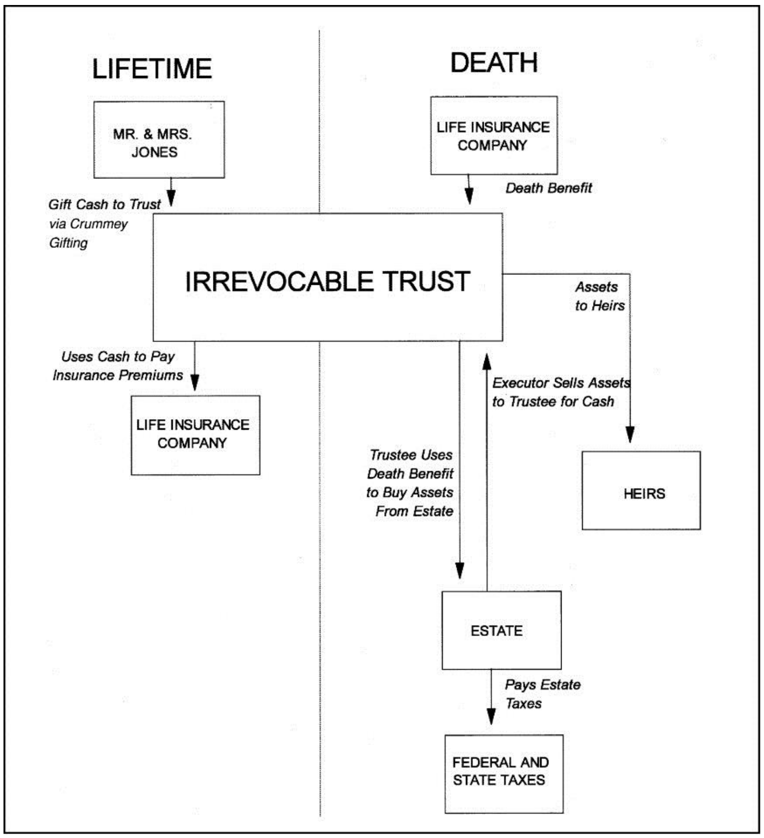



**FIGURE 4-7** How a Life Insurance Trust Works

A life insurance trust helps in the distribution of the benefit. Most importantly it takes the proceeds out of the estate of the owner and places it in the trust. This removes it from the estate for tax purposes.

ADDITIONAL LIFE INSURANCE PLANNING TECHNIQUES for businesses

Buy-Sell Agreement

Key Man Insurance

Split Dollar Policies

There are many business needs for life insurance. It can be used to assist in the transfer of assets upon the death of an owner or partner.

Split dollar is an older way to get insurance from a company. The ultimate goal was to defer income. The IRS has since concluded that this type of insurance has taxable consequences.